3 A Theoretical Framework for Voluntary Corporate Governance

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INTRODUCTION

One of the cornerstones of corporate governance research is the idea that better corporate governance practices are a source of competitive advantage, either through lower capital costs or higher stock prices. Anand (2005, 19) is an example of such a view: "companies have a strong incentive to institute corporate governance practices voluntarily in order to deter or prevent investors from devaluing the company." Assuming this is true irrespective of company or market characteristics, market competition would lead companies to adopt better corporate governance practices and would result in dynamic positive feedback, and there wouldn't be any need for best corporate governance codes or any form of stringent regulations.

In this chapter I argue that the incentives to pursue voluntary corporate governance are much more complex than simple market mechanisms, and also depend on the institutional framework and endogenous and exogenous mechanisms faced by companies in different contexts. Here I implicitly follow the skepticism of Shleifer and Vishny (1997) regarding competition as the main driver of voluntary corporate governance—the authors argue:

> While we agree that product market competition is probably the most powerful force toward economic efficiency in the world, we are skeptical that it alone can solve the problem of corporate governance. One could imagine a scenario in which entrepreneurs rent labor and capital on the spot market every minute at a competitive price, and hence have no resources left over to divert to their own use. But in actual practice, production capital is highly specific and sunk, and entrepreneurs cannot rent it every minute. (738)

Especially relevant to this discussion is geography: the structure of capital markets varies significantly around the world, and thus there are different incentives dependent on each particular market for companies to adopt better governance practices. Whereas the American market probably presents the best structure in terms of market incentives for companies to reduce information asymmetry through the adoption of better corporate governance practices, that is not true in many markets around the world, especially in emerging markets. In this chapter I try to derive a theoretical framework that encompasses different possible capital market structures in the search of a model that maps the incentives for the voluntary adoption of better corporate governance.

CAPITAL MARKET STRUCTURES AND CORPORATE GOVERNANCE

There are two basic contexts or paradigmatic models to classify international environments of corporate governance. First is the Anglo-Saxon model, where property is dispersed and the stock market has an important role in allowing liquidity and facilitating the exit of shareholders. Variations in stock prices reflect the amount of agreement, by market players, with the strategies traced by the publicly listed companies and the evaluation of their performance. The control systems of corporate governance are strongly influenced by the negotiation of shares and takeovers.

In the second context, known as the Japanese-German model, the ownership is concentrated in banks or economic groups (or in family-owned companies in many emergent countries), and there are cross holdings, with frequent involvement of workers and representatives of society on the boards of directors. This concentration of ownership fosters the use of internal instruments of control exercised by shareholders.

These two models can also be classified as exit and voice (Buck et al. 1999). In the Anglo-Saxon model, or exit, the behavior of managers is constrained by the threat of shareholders to sell their shares and leave the company. In the Japanese-German model, or voice, there is greater involvement of shareholders in the business decisions and controlling mechanisms, including the participation of nonshareholders, like employees, on the board.

The definition of these models helps to establish paradigmatic assumptions about the existence of links between economic, social, cultural, and institutional development of a country and, in particular, the methods of financing companies and adoption of corporate governance practices. There are important research questions regarding the identification of particular forms of ownership in a country or region. This identification problem can arise from two kinds of pressure: exogenous and endogenous pressures.

In analyzing an endogenous perspective, Demsetz and Lehn (1985) argue that the ownership is the outcome of decisions made by shareholders in order to maximize their profits. That means the ownership structure is an endogenous outcome of share trading by profit-maximizing shareholders (Kapopoulos and Lazaretou 2007). In a later study, Demsetz and Villalonga (2001) argued that the ownership structure should be modeled simultaneously as an amalgam of shareholdings owned by persons with different interests, including managers. In their words, "persistent diffuseness of a company's ownership structure plausibly serves the company's shareholders better than would a concentrated ownership structure, even if more diffuseness of ownership would allow professional management to divert more of the company's resources to serve its own narrow interests" (216).

However, the endogenous model is unable to answer the structure of family-owned companies in many countries. A business structure based on state-owned and family enterprises does not appear to be one that solely seeks to maximize profits. Thomsen and Pedersen (1996), following an exogenous perspective, place two hypotheses for investigation. First, what they call the industry effect—corporate ownership patterns will vary across industries beyond what differences in company size can explain. Second, the nation effect—that is, political, institutional, and cultural differences between nations will have an independent impact on corporate ownership patterns beyond what differences in industrial structure can explain. They found nation-specific differences in the ownership structures of companies in Europe, and also found that economic conditions like industry and company size influence those structures.

This exogenous perspective can also be associated with the issues of culture and institutional environment. La Porta, Lopez-de-Silanes, and Shleifer (1999) related ownership dispersion and the system of law, and found that in countries where the judicial system does not present good protection for investors there is a high concentration of ownership as a substitute for the weak protection. An example of costs associated with this concentrated ownership structure is that these companies "probably face difficulty raising equity finance, since minority investors fear expropriation by managers and concentrated owners" (1151).

We arrive then at the situation that voluntary corporate governance is the result of two different pressures: the structure of capital markets (either voice or exit) and institutional and cultural national idiosyncrasies. Countries with exit models, like the United States, present the best environment for competition to enhance the benefits of voluntary corporate governance, whereas the reverse is true in countries where voice is more relevant—the possibilities of gains through concentrated ownership are higher and thus there is less benefit in adopting higher standards of corporate governance.

Besides the main structure of capital markets—exit or voice—institutional and cultural idiosyncrasies would also change the cost-benefit ratio of voluntary corporate governance for companies in different countries. This would allow for a continuum of different incentives for the adoption of corporate governance best practices, and the ultimate companies' decision would also be based on the internal factors that would translate the different incentives to a particular decision-ruling mechanism. Because different environments change the incentives for companies to adopt better corporate governance practices, and in many cases render market competition ineffective as a driver of voluntary corporate governance, I turn to ask: which internal factors to the companies would yield better corporate governance practices, even in an environment where companies have few external incentives to do so, like in the case of many countries that follow the voice model? Here I depart from the literature, which aside from some papers that deal with cross-country examples and empirical investigations (Drobetz, Schillhofer, and Zimmermann 2003 for Germany; Black, Jang, and Kim 2006 for Korea; de Jong et al. 2002 for the Netherlands; Beiner et al. 2004 for Switzerland; Leal and Carvalhal-da-Silva 2005 for Brazil; Black 2001 for Russia; Bauer, Guenster, and Otten 2004 and 2008 for Europe; and Bauer et al. 2008 for Japan), mainly focus on corporate governance issues in the U.S. market, where there are enough market incentives that competition is a major driver of governance best practices.

INTERNAL DETERMINANTS OF VOLUNTARY CORPORATE GOVERNANCE

The idea that market competition is the only driver of voluntary corporate governance is insufficient to explain the patterns of voluntary corporate governance around the world. Looking at the company as the decision unit, market considerations are only one class of variables to be taken into consideration in the decision to adopt better corporate governance practices. Here I will try to analyze each component of the decision vector, trying to develop a theoretical framework that encompasses the decision model irrespective of the structure of each country's capital markets. In this way, companies in countries in capital markets with the Anglo-Saxon structure (exit) would be more affected by market competition variables than companies in the countries with the Japanese-German (voice) structure. The main theoretical division is then between market and nonmarket variables influencing the companies' decisions.

Market Variables

There are three ways in which market mechanisms can influence the companies' decisions to adopt better governance practices: market value, lower capital costs, and realized positive feedback. The first two are self-explanatory and are the focus of most papers on corporate governance practices. The positive feedback argument is related to the two paradigmatic models, exit and voice. In the Anglo-Saxon model, companies have the incentive to pursue better corporate practices just because all other companies are acting in the same way. This incentive is already realized by past market developments, and deviation can be severely punished. This would be translated in a special case of realized path dependence. Companies with poor governance are readily devalued, and arguments like the one advanced by Anand (2005) hold. One of the main changes happening in many markets around the world is the development of capital markets to induce positive feedback. This is being done through new regulations and codes of conduct, or even the creation of higher corporate governance standards markets, like the Neuer Markt for technology shares in Germany and the Novo Mercado in Brazil. Even though some authors (one example is Corbett and Jenkinson 1996) have questioned the foundations of the Anglo-Saxon model, arguing that self-financing is more important than market funding, there is clear evidence of peer pressure in the corporate governance decisions of companies in the U.S. and UK markets, and some countries are trying to emulate that by trying to create incentives that will trigger positive feedbacks in the adoption of better corporate governance practices by local companies.

Nonmarket Variables

Controlling shareholders have a strong incentive to maintain a poor governance structure in many countries. An anecdotal example shows this: after the crisis of 2008, a listed company from the phone sector in Brazil with excess cash holdings announced a record dividend payment of R$3.07 per share, when the share was at R$31. The reason for this record dividend of almost 10 percent of the company's value was that the controlling shareholder was another company that suffered a strong liquidity squeeze during the crisis and used the excess cash of the phone company to ease the liquidity pressure of the parent company. Small shareholders were of course appalled by the dividend payment and many tried to stop the company from disbursing an amount of cash that made the company much less liquid to pursue new projects. When faced with possibilities like this many companies would rather maintain a poor governance structure than choose better practices, even if those practices come with higher market value and lower capital costs. In fact, many agency problems that are prevalent in the American market disappear in a context where companies have owners that can single-handedly decide all strategies and have a vested interest in the managers' decisions.

In markets where companies with controlling shareholders are the norm, like in many countries with voice models, what are the reasons that may give companies incentives to pursue better corporate governance practices—which incentives can supplant the many benefits from ownership? I give four reasons for a comprehensive model of voluntary corporate governance that deals with nonmarket variables: exit via liquidity, the role of institutional investors, conflict resolution, and path dependence.

Exit

The necessity of controlling shareholders to exit via the market may make companies search for better corporate governance practices—what Aguilera and Jackson (2003) call liquidity, or "the ability of owners to exit by selling their stakes without a loss of price" (451). Controlling shareholders can exit through selling the controlling shares as a block or via the market. Usually the first is preferred, but many reasons can make exit via the market attractive, such as periods of market boom, overvaluation of the company, or even capital market imperfections—there may not be any agent with the ability to raise enough capital to purchase the whole block of controlling shares. In exiting via the market good corporate governance practices can enhance the liquidity of the company's shares, and reduce information asymmetry that will make the company more attractive for investors—the same information asymmetry that allows controlling shareholders to pursue expropriation strategies.

Institutional Investors

Many institutional investors, like pension funds, public investment banks, and others, have important stakes in publicly listed companies. Pension funds, particularly, are active shareholders and usually try to promote corporate governance best practices as part of their long-term strategies (for a comprehensive analysis of shareholders activism and its importance in promoting governance best practices, see Gillan and Starks 2000). In many countries that follow the Japanese-German model institutional investors are the leading agents of corporate governance transformation. One such example is Brazil, where companies like Previ and Petros (both pension funds) and BNDES (one of the biggest public investment banks in the world) are active promoters of changes in the governance structure of companies in which they have significant voice.

Conflict Resolution

Conflict between controlling shareholders or between shareholders and management can lead to better governance practices by turning implicit strategies in explicit company policies. Ingley and Van-Der Walt (2004) explored this idea in the American context, with recommendations for changing the architecture of boards of directors. In the concentrated ownership structure of many countries conflicts between shareholders and the board are rare, because controlling shareholders can just change the board to align their interests with management. Even so, conflicts between shareholders with big stakes are much more common, and sometimes result in periods of power vacuums that can be explored by management to enforce better corporate governance practices with the objective of more board independence.

Path Dependence

Although initial conditions for capital markets structure are an important reason for differences between capital markets in the world and are a main source of the theoretical separation between the Anglo-Saxon and Japanese-German models, they are also a source of convergence as markets develop. Bebchuk and Roe (1999) have shown the relevance of path dependence in shaping capital markets, and corporate governance as a result. As markets develop, there should be a natural process of convergence on corporate governance practices around the world, even if only as a result of enough companies going through changes that would lead them to, at one point in time, adopt better governance practices. Because reversing such practices is costly, the amount of companies adopting improved practices should be increasing at all times and positive feedback should ensure a better governance environment in the future. However, differently from the market mechanism of positive feedback, this is a tentative path dependence, because as Schmidt and Spindler (2002) have argued, there is a possibility of 'inefficient convergence,' in which bad governance practices are reinforced over time. Even so, and especially in emergent markets that want to rapidly increase the relevance of national capital markets, mechanisms that enhance efficient convergence are procured as a way to enhance markets' liquidity. Adding to that, the development of capital markets can change one of the more important characteristics of capital markets in emerging markets, that of ownership culture. In many countries there is a cultural preference to concentrated ownership, and family-owned companies are the norm. One such example is Brazil, where the property culture is so prevalent that the number of companies with dispersed ownership is very small. Zeidan and Fontes Filho (2008) present a historical perspective that shows that path dependence is changing this cultural landscape, but at a slow pace.

FINAL CONSIDERATIONS

The idea that corporate governance stems from agency problems is central to the Anglo-Saxon model, but is insufficient to explain the patterns of corporate governance practices around the world. Instead of codes and rules of conducts, here I focus on voluntary mechanisms for companies to pursue better governance practices. I separate the mechanisms in market and nonmarket mechanisms, and argue that whereas market mechanisms may be sufficient to explain the voluntary decision in companies located in markets with exit characteristics, for companies in emergent markets and other places with Japanese-German characteristics, nonmarket mechanisms can play a large role in the decision to voluntarily adopt better governance practices.

I classify the nonmarket mechanisms as four: exit, institutional investors, conflict resolution, and path dependence. These four mechanisms have been explored in the literature, and here what I try to achieve is to formalize a theoretical framework that can explain companies' decisions irrespective of capital markets' structures. Understanding which variables are relevant to the companies' decisions is particularly relevant for the design of public policy that can try to foster an environment conducive to self-determination of better corporate governance practices, complementing the top-down approach of codes of conduct and other kinds of regulation.

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