ARTICLES

Corporate Practices and National Governance Systems: What do Country Rankings Tell Us?

By Peter Cornelius[*]

Abstract

Nations compete for investment capital, and the assurances investors seek as they decide to provide that capital are universal. Motivated by the growing appetite for a global benchmark of corporate behaviour, this paper examines the relationship between the measured quality of corporate governance at the firm level and national competitiveness. It begins by analyzing the perceived quality of institutions in the 23 largest capital markets. Hypothesizing that good corporate governance at the company level may compensate for perceived weaknesses in the institutional framework, the paper then focuses on the pilot governance index developed by the Financial Times and ISS and compares it with new survey evidence from the World Economic Forum's Global Competitiveness Report. Finally, the paper discusses corporate governance in the EU accession countries and the extent to which the quality of governance has affected the mode of entry for foreign investment.

A. Introduction

In the broadest sense, corporate governance can be defined as the stewardship responsibility of corporate directors to provide oversight for the goals and strategies of a company and to foster their implementation. Corporate governance may thus be perceived as the set of interlocking rules by which corporations, shareholders and management govern their behavior. These rules refer to individual firm attributes and the factors that allow companies to maintain sound governance practices even where public institutions are relatively weak. Such factors may include a corporation's ownership structure, its relationships with stakeholders, financial transparency, and information disclosure practices as well as the configuration of its managing boards.

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In any given country, the legal system helps define a specific range of corporate governance standards. These may vary, and while absolute conformity of corporate governance systems is both unnecessary and unlikely to be very healthy, there is near universal recognition of the need to preserve investor confidence through transparency, accountability, fairness, and responsibility.[1] This recognition has driven and continues to drive convergence on notions of governance and what constitutes best practice, despite differences in legal origins, regulatory systems, and governance models.

That there are standards that can apply across a broad range of legal, political, and economic environments is at the core of the Principles of Corporate Governance developed by the Organization for Economic Co-operation and Development (OECD).[2] First published in 1999, the original Principles focused on the rights of shareholders, their equitable treatment, the role of stakeholders in corporate governance, disclosure and transparency, and the responsibilities of the board. In April 2004, these Principles were revised.[3] Specifically, the new principles encourage institutional investors to disclose their corporate governance policies, emphasize the need for strengthening the rights of investors, including their ability to remove board members, call for rating agencies and analysts to avoid conflicts of interest, make reference to the rights of stakeholders and advocates protection for whistleblowers, and clarify board responsibilities.

The OECD Principles provide thoughtful guidance to nations seeking to improve corporate governance and serve as the basis for numerous detailed corporate governance standards throughout the world. Emphasizing the importance of a regulatory framework in corporate governance that promotes efficient markets, the Principles recognize that capital is the essential factor in any growing economy: nations compete for investment capital, and the assurances investors seek as they decide whether to provide that capital are universal. Investors ultimately choose to

[1] For this argument, *see* LUTGART VAN DEN BERGHE, CORPORATE GOVERNANCE IN A GLOBALISING WORLD: CONVERGENCE OR DIVERGENCE? A EUROPEAN PERSPECTIVE (2002); this notion has recently again been underscored by the new EU Internal Market Commissioner, Charlie McGreevy, at the occasion of announcing the European Corporate Governance Forum in Brussels, 20 January 2005, *available at* http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/05/26&format=HTML&aged=0&language=EN&guiLanguage=en (last visited 21 February 2005.

[2] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD PRINCIPLES OF CORPORATE GOVERNANCE 1999 (OECD, 1999).

[3] *See* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD PRINCIPLES OF CORPORATE GOVERNANCE 2004 (OECD, 2004), *available at* http://www.oecd.org/dataoecd/32/18/31557724.pdf. Last visited 22 February 2005.

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place their capital where they can understand the risks and believe their investment is most likely to be protected from fraud or other misuse.

Given that good corporate governance can help create shareholder value regardless of the particular system,[4] investors have shown a growing demand for a global benchmark of good corporate behavior. Responding to this demand, the *Financial Times*, a major index supplier, has recently produced, in partnership with *International Shareholder Services* (ISS), a pilot Corporate Governance Index.[5] The first of its kind, the index benchmarks companies on the basis of five globally comparable criteria and ranks countries according to the average governance ratings. Although initially this index may be not much more than a box-ticking exercise so that large institutional investors will continue to rely on their own research or on detailed assessments the rating agencies or external advisors offer, eventually this project could evolve into a generally accepted yardstick.

Against this background, this paper examines the relationship between the measured quality of corporate governance at the firm level and national competitiveness employing the new FTSE/ISS index. In so doing, we first analyze the extent to which legal and regulatory indicators of corporate governance at the country level correspond to the perceived quality of governance systems. Then, the paper focuses on the quality of corporate governance practices at the company level benchmarked by the new index. Hypothesizing that good corporate governance at the company level may compensate for perceived weaknesses in the institutional framework, a key determinant of national competitiveness and sustained economic growth, we then juxtapose the FTSE/ISS index with recent survey evidence from the World Economic Forum's Global Competitiveness Report on board practices. Finally, we look at the transition countries in Central and Eastern Europe, which recently joined the European Union and discuss whether the quality of corporate governance systematically affects the mode of entry for foreign investment.

B. Corporate governance systems and the perceived quality of institutions

For investors it is vital to examine both the quality of corporate governance at the firm level and the quality of the institutional and regulatory framework within which companies operate.[6] Country factors can play a key role in setting the

[4] *See* P. Gompers, et al., *Corporate Governance and Equity Prices*, 107 QUARTERLY J. OF ECON. 118 (2003).

[5] Full details can be assessed at http://www.ftse.com/corpgov. Last visited 23 February 2005.

[6] *See* D. Kaufmann, et al., *M. Governance Matters III: Governance Indicators 1996-2002*, (Draft 2003), *available at* http://www.worldbank.org/wbi/governance/pdf/govmatters3.pdf; last visited 22 February 2005; WORLD BANK, DOING BUSINESS IN 2004. UNDERSTANDING REGULATION (2004); J. Kurtzman, et al., *The Global Costs of Opacity*, 26 MIT SLOAN MANAGEMENT REV. 1 (2004).

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framework for corporate governance practice at the individual company level. Legal, political, historical and cultural factors interact and help determine ownership structures, stakeholder priorities and fundamental attitudes towards the role of the firm in the economy.[7] Thus, assessing corporate governance risk at the company level requires analyzing country risk factors. For example, two companies with the same risk profile but domiciled in countries with contrasting legal, regulatory and market standards, present different risk profiles should their governance practices deteriorate. In other words, in the event of deterioration in a specific company's governance standards, investors and stakeholders are likely to receive better protection in a country with stronger and better enforced laws and regulations.

While the country environment can influence the articulation and practical protection of ownership rights and the norms of transparency and disclosure, positive framework conditions are no guarantee that all companies in a given framework will demonstrate strong corporate governance standards. Thus, investors and rating agencies, such as Standard&Poors do not regard the quality of the macro framework of corporate governance as a floor.[8] Conversely, it is conceivable that companies operating in weak country environments transcend local practice. However, companies whose corporate governance standards are perceived to be high are generally seen as less risky than companies with low standards, irrespective of the country of domicile. In other words, whereas good corporate governance at the company level may compensate for weak framework conditions, the opposite is not true.

Note that the underlying approach of risk assessments with regard to corporate governance deviates from credit risk assessments. In credit analysis, the concept of a sovereign ceiling implies that the credit rating of an individual company can be constrained by the credit rating of its country of domicile. As Dallas argues, however, applying the same principle in corporate governance analysis would be self-defeating: "Part of the logic of a governance rating system is to provide a positive incentive structure for individual firm improvement. To imply that an individual firm in a weak country environment cannot have anything but weak corporate governance itself is not only wrong, but it could also have perverse implications. Namely, an artificial ceiling might de-motivate a firm from making

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[7] G. Dallas, *Country Influences on Individual Company Governance*, *in*, GOVERNANCE AND RISK 138 (G. Dallas ed., 2004).

[8] Standard & Poor's (2004), Standard & Poor's Corporate Governance Scores – Criteria, Methodology and Definitions, *available at* http:/www.standardandpoors.com.

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positive improvements in its own governance standards if such improvements were not reflected in its standalone governance rating assessment."[9]

The quality of the legal system plays a particularly important role, with strong investor protection laws generally linked with broader and deeper capital markets, a more dispersed shareholder base, and a more efficient allocation of capital across firms.[10] Thus, a rapidly expanding strand in the literature, led by La Porta, Lopez de-Silvanes, Shleifer, and Vishny, focuses on different systems of corporate governance and attempts to assess their quality in a systematic way. Broadly speaking, "a system of corporate governance consists of those formal and informal institutions, laws, values, and rules that generate the menu of legal and organizational forms available in a country and which in turn determine the distribution of power – how ownership is assigned, managerial decisions are made and monitored, information is audited and released, and profits and benefits allocated and distributed."[11]

The "law matters" school focuses especially on issues relating to legal family origin (exhibit 1).[12] Specifically, it is found that institutions and regulation vary systematically across countries, reflecting their individual history and influences. England developed a common-law tradition, characterized by independent judges and juries. In this tradition, comparatively low importance is paid to regulation, whereas private litigation is preferred as a means of addressing social problems. The common-law tradition was exported by England to the United States, Canada (except for Quebec), Australia, and New Zealand as well as to several developing countries in Asia, East Africa, and the Caribbean.

France, by contrast, developed a civil-law tradition. Based on Roman law, this tradition is characterized by state-employed judges, a preference for state regulation over private litigation and emphasis on legal and procedural codes. Napoleon transplanted the French legal system to Spain, Portugal and Holland, and through his and subsequent conquests it was further exported to all of Latin

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[9] Dallas, *supra* note 7, at 149-50.

[10] R. La Porta, et al., *Investor Protection and Corporate Valuation*, 57 J. OF FIN 1147 (2002).

[11] P. K. Cornelius & B. Kogut, *Introduction* to CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY 2 (P.K. Cornelius & B. Kogut eds., 2003).

[12] R. La Porta, et al., *Legal Determinants of External Finance*, 52 J. OF FIN. 1131 (1997); B. R. CHEFFINS, LAW AS BEDROCK: THE FOUNDATIONS OF AN ECONOMY DOMINATED BY WIDELY HELD PUBLIC COMPANIES, (2001); L.A. Bebchuk, et al., *What Matters in Corporate Governance?*, HARVARD LAW & ECONOMICS DISCUSSION PAPER NO. 491 (2004).

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America, Quebec, large parts of Europe, North and West Africa, parts of the Caribbean, and parts of Asia.[13]

The civil-law traditions in Germany and the Nordic countries are also based on Roman law. The German legal system was adopted voluntarily in Japan, and through Japan it influenced the legal systems in several other Asian countries, notably China, Korea, and Taiwan. Austria and Switzerland were also influenced by Germany's civil-law tradition, and through the Austro-Hungarian Empire, much of central and Eastern Europe inherited German commercial laws.

In a large cross-section of countries, it is found that legal origin is one of the most important variables for explaining different levels of regulatory intervention.[14] Specifically, it is argued that legal origin is associated with differing degrees of greater procedural formalism and complexity, a concept that relates to how effectively the prevailing legal system, and its court system in particular, is in enforcing the law. Indeed, civil law countries tend to show a comparatively higher degree of complexity on an index, which attempts to measure substantive and procedural statutory intervention in civil cases in the courts.[15]

More provocatively, however, it is argued that civil law is less effective in protecting shareholder rights than common law. To show this, La Porta et al. have developed an anti-director rights index.[16] Measuring how strongly a country's legal

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[13] *See* World Bank, *supra* note 6, at 84.

[14] *Id.* at 85-7.

[15] The procedural complexity index consists of six sub-indexes: (1) Use of professionals: This sub-index measures whether the resolution of the case provided relies mostly in the intervention of professional judges and attorneys, as opposed to the intervention of other types of adjudicators and lay people. (2) Nature of actions: This sub-index mirrors the written or oral nature of the actions involved in the procedure, from the filing of the complaint to enforcement. (3) Legal justification: This sub-index reflects the level of legal justification required in the process of dispute resolution. (4) Statutory regulation of evidence: This sub-index measures the level of statutory control or intervention of the administration, admissibility, evaluation, and recording of evidence. (5) Control of superior review: This sub-index mirrors the level of control or intervention of the appellate court's review of the first instance judgement. (6) Other statutory interventions: This sub-index measures the formalities required to engage someone into the procedure or to hold him accountable for the judgement. The index, which ranges from 0 to 100, has been developed by Djankov et al. See S. Djankov, et al., *Courts*, 118 QUARTERLY J. OF ECON. 453 (2003).

[16] The anti-director rights index consists of five variables: (1) Proxy by mail allowed. In some countries, shareholders must show up in person or send an authorized representative to a shareholders' meeting in order to vote. By contrast, some countries allow shareholders to mail their proxy vote directly to the firm, thus making it easier to cast their vote. (2) Shares not blocked before meeting. Some countries have laws that require shareholders to deposit their shares with the company or a financial intermediary several days prior to a shareholder meeting. These shares are then kept in custody until a few days after

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system favours minority shareholders against managers or dominant shareholders in the corporate decision-making process, this index has become a standard reference in measuring the quality of the institutional framework of individual countries. For each of the five anti-director rights measures, a country gets a score of 1 if it protects minority shareholders according to this measure and a score of 0 otherwise.

Exhibit 1. Legal Characteristics

Country	Legal Origin	Procedural Complexity Index	Anti-Director Rights Index
Australia	English	29	4
Austria	German	54	2
Belgium	French	53	0
Canada	English	29	4
Denmark	Nordic	40	3
Finland	Nordic	48	2
France	French	79	2
Germany	Germany	61	1
Greece	French	64	1
Hong Kong	English	50	4
Ireland	English	42	3
Italy	French	64	0
Japan	German	39	3
Netherlands	French	46	2
New Zealand	English	31	4
Norway	Nordic	48	3
Portugal	French	54	2
Singapore	English	49	3
Spain	French	83	2
Sweden	Nordic	44	2

the meeting, a practice that prevents shareholders from selling their shares for several days around the time of the meeting. (3) Cumulative voting/proportional representation. Some countries have mechanisms by which minority interests may name a proportional number of directors, which then grants power to minority shareholders to put their representatives on boards of directors. (4) Oppressed minority. Countries sometimes grant minority shareholders legal mechanisms to check the powers of directors. These mechanisms may include the right to challenge directors' decisions in court (as in the American derivative suit) or the right to force the company to repurchase shares of the minority shareholders who object to certain fundamental decisions such as mergers or asset sales. (5) Minimum percentage of share capital that entitles a shareholder to call for an extraordinary shareholders' meeting is less than or equal to 10%. For details, *see* R. La Porta, et al., *Law and Finance*, 106 J. OF POL. ECON. 1113 (1998).

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Switzerland	German	44	1
UK	English	36	4
USA	English	46	5

While common law countries with high incomes tend to have less complex procedures and better anti-director rights according to the respective indexes, the influence of law must be viewed in a wider context. As Dallas argues, for example, it is clear that in many emerging economies operating with British common law systems (e.g. Bangladesh, Nigeria, Pakistan, Zimbabwe) common law alone is not a determinant of an effective legal environment, nor has it resulted in widely held ownership structures.[17] Other factors may be equally, if not more relevant in determining legal and governance systems, such as the stage of economic development, the political environment, and even broader cultural issues.

Thus, La Porta et al.'s findings have not remained undisputed. Instead, it has been argued that there is no single system of corporate governance – that works in all countries and all companies.[18] Specifically, it has been stressed that the cultural and historical backgrounds of countries differ – as do their political conditions, and thus, their corporate governance systems. But for a given type of form, so the counter-argument goes, one can identify specific practices that are better than others. Corporate governance practices are those rules that apply to specific financial markets and organizational forms and establish the rights of owners, and the information and mechanisms at their disposal, to control management and employees. These practices for the public firm include the determination of the board of directors and its powers and voting rules, protection of minority investors, the publication of audited accounts, covenants restricting managerial actions such as the sale of assets, and the distribution of profits.

Against this background, recent benchmarking attempts have encompassed a wider range of components, which are believed to determine the quality of corporate governance at the macro level. While some attempts focus on broader public governance issues, such as the World Bank's composite governance index and Transparency International's Corruption Perceptions Index,[19] other have focused more narrowly on specific corporate governance criteria, which can be divided into four categories: Market infrastructure, legal infrastructure, regulatory infrastructure, and informational infrastructure. Some of the criteria are objective in

[17] *See* Dallas *supra* note 7, at 142.

[18] *See* Cornelius and Kogut, *supra* note 11, at 3.

[19] Kaufmann, *supra* note 6.

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the sense that they reflect specific regulations and the "law on the books." How regulations and laws are applies and enforced in practice is a different matter, however.[20] Therefore, most attempts to measure the quality of public and corporate governance also include survey data.

In this regard, the World Economic Forum's executive opinion survey for its Global Competitiveness Report (GCR) contains especially useful information as it covers a particularly large sample of countries and reflects the views of more than 7,500 senior executives. Working with a large number of local partner institutes, the World Economic Forum endeavors to ensure that the survey is representative with regard to the size of the firms of a country, the ownership structure and market orientation.[21] Around two-thirds of the respondents are domestic investors while the rest represent foreign companies.

Blending survey data with "hard" data (i.e., publicly available statistical data, such as GDP, inflation, budgetary balances etc), the Forum ranks more than 100 countries according to their competitiveness – defined as an economy's ability to achieve sustained economic growth over the medium term. One of the sub-indexes that are used to calculate the overall rankings reflects the quality of the legal environment. Based solely on survey evidence, the Contracts and Law Index mirrors responses to four questions focusing on the independence of the judiciary, the protection of property rights, favoritism, and the prevalence of organized crime (Box 1). The rankings for high-income countries are shown in Exhibit 2.

Box 1. GCR Contracts and Law Index

The judiciary in your country is independent from political influences of members of government, citizens, or firms (1 = no, heavily influenced, 7 = yes, entirely independent).

Financial assets and wealth (1 = are poorly delineated and not protected by law, 7 = are clearly delineated and well protected by law).

When deciding upon policies and contracts, government officials (1=usually favor well-connected firms and individuals, 7 = are neutral among firms and individuals)

*Organized crime (e.g. mafia-oriented racketeering, extortion) in your country (1= imposes significant costs on businesses, 7=does not impose significant costs on business).*In last

[20] K. Pistor & D. Berkowitz, *Of Legal Transplants, Legal Irritants, and Economic Development*, *in* CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY 347 (P.K. Cornelius & B. Kogut eds., 2003).

[21] *See* WORLD ECONOMIC FORUM, THE GLOBAL COMPETITIVENESS REPORT 2003-2004 (2004).

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year's survey, the World Economic Forum introduced several new questions on corporate governance, some dealing with institutional and legal issues (e.g., protection of minority shareholders), others with firm-specific factors (e.g., control of corporate boards). The specific questions are included in Box 2, and the results are also shown in Exhibit 2.

Box 2. GCR Survey Questions on Corporate Governance Framework

Law protection of minority shareholders' interests in your country is
(1 = nonexistent and seldom recognized by majority shareholders, 7 = total and actively enforced).

Financial auditing and accounting standards in your country are
(1 = extremely weak, 7 = extremely strong, among the best in the world)

Access to reliable and timely information regarding company financial performance is
(1 = often insufficient, delayed, and difficult to obtain, 7 = regular and easy).

The regulation of securities exchanges in your country is (1 = nontransparent, ineffective, and subject to excessive industry and government influences,
7 = transparent, effective, and independent of excessive industry and government influences).

In your country, mergers and acquisitions – particularly hostile takeovers – are
(1 = rare and face serious legal impediments, 7 = common and allowed by law).

On the contracts and law index, the Nordic countries Finland, Denmark and Sweden enjoy particularly high scores. Australia and New Zealand are also ranked highly. While Italy and Spain, two civil law countries of French origin, score lowest, there appears to be no systematic differences between common law and civil law countries. France and Canada, for instance, are indistinguishable on this account, and Germany and Switzerland enjoy higher rankings than the UK and the US.

As far as the protection of minority shareholders are concerned, common law countries are generally perceived to provide better protection. This applies especially to Australia and the UK. However, the Nordic countries are not much behind, with Finland and Denmark scoring higher than the US. As regards the latter, the high-profile scandals such as Enron and WorldCom might have affected respondents' views. The perceived degree of protection of minority shareholders in

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civil law countries varies considerably, with those of French origin generally scoring comparatively lower. Again, among the high-income countries included in exhibit 2 Italy and Spain have the lowest rankings. Japan, a civil law country with German roots, scores equally poorly.

Exhibit 2. Perceived quality of public institutions

Country	Contracts and Law Index (1)	Law Protection of Minority Shareholders' Interests (2)	Strength of Auditing and Accounting Standards (3)	Availability of Company Financial Information (4)	Regulation of Security Exchanges (5)	Prevalence of Mergers and Acquisitions (6)	Unweighted Average (2-6) (7)
Australia	6.10	6.4	6.4	6.7	6.7	6.1	6.5
Austria	5.47	5.0	6.0	4.8	5.6	4.1	5.1
Belgium	5.00	5.6	5.9	5.8	5.6	4.6	5.5
Canada	4.99	5.8	6.2	6.0	5.6	5.1	5.7
Denmark	6.30	6.1	6.3	6.2	6.3	5.3	6.0
Finland	6.35	6.2	6.1	6.5	6.2	5.0	6.0
France	4.96	5.1	6.2	5.5	5.9	5.0	5.5
Germany	5.80	5.9	6.1	5.7	6.2	4.5	5.7
Greece	4.63	5.1	4.8	5.1	4.8	4.1	4.8
Hong Kong	5.65	5.4	6.0	5.7	5.9	5.1	5.6
Ireland	4.88	5.3	6.0	5.5	6.1	5.3	5.6
Italy	4.15	4.3	5.3	5.1	5.2	4.6	4.9
Japan	4.57	4.5	4.8	4.9	4.6	3.9	4.5
Netherlands	5.66	5.0	6.1	6.0	5.9	4.0	5.4
New Zealand	6.03	6.0	6.2	6.2	6.1	5.7	6.0
Norway	5.40	5.7	5.7	5.9	5.6	4.8	5.5
Portugal	5.22	4.9	5.3	5.0	5.3	3.6	4.8
Singapore	5.89	5.8	6.1	6.0	6.2	5.0	5.8
Spain	4.46	4.6	5.3	4.8	5.3	4.5	4.9
Sweden	6.00	5.9	6.2	6.7	6.0	5.1	6.0
Switzerland	5.87	4.9	5.8	5.3	6.1	4.9	5.4
UK	5.67	6.4	6.6	6.6	6.6	6.5	6.5
USA	5.42	5.9	5.8	6.1	6.0	6.1	6.0

Australia and the UK also lead the rankings in terms of the perceived strength of auditing and accounting standards, the availability of company financial information, the regulation of security exchanges and the prevalence of mergers and acquisitions. Overall, they both score an unweighted average of 6.5 on a scale ranging from 1 to 7. At the other end of the spectrum is Japan with an overall score

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of 4.5. Some civil law countries of French origin, such as Italy, Greece, Portugal and Spain, also have relatively low scores, which appears to be consistent with La Porta et al's hypothesis discussed above. However, most of the countries cluster in the 5 – 6 range, suggesting that any systematic impact from the legal origin of a country appears relatively weak. Moreover, from the survey results it is not clear to what extent differences across countries are driven by legal factors as opposed to other variables, including income levels, political preferences and cultural and historical roots.

Although there remains uncertainty as to the precise drivers of the quality of a country's corporate governance framework, corporate governance practices at the company level may offset weak framework conditions. The following section discusses different efforts to benchmark such practices and derive country rankings by aggregating company assessments.

C. Benchmarking firm-level corporate governance

Whereas the preceding analysis has focused on the legal and institutional framework of corporate governance, investors are equally, if not more, interested in the quality of corporate governance of the company they plan to invest in. Firm-level corporate governance provisions matter especially in countries with weak legal environments, potentially compensating for ineffective laws and enforcement by providing credible investor protection. [22] According to a recent survey by McKinsey among 200 institutional investors, well over 70 percent of the respondents in each region were willing to pay more for a well-governed company, all other things being equal.[23] The McKinsey survey suggests that the quality of corporate governance at the firm level is most valuable to investors where the disclosure and legal framework protecting shareholders is perceived as weakest.

Many investors would welcome an index that rates companies according to their corporate governance practices. While the main benefit of such an index would be to provide a benchmark that can serve as a thumbnail sketch of a company, its construction is fraught with a number of practical difficulties. A key problem is that corporate governance is difficult to measure, especially at the firm level. There are many variable factors and many subjective areas, which are difficult to be incorporated into one single figure. And how does one create an international index

[22] *See* L.F. Klapper, & I. Love, *Corporate Governance, Investor Protection, and Performance in Emerging Markets*, J. OF CORPORATE FIN. (2004).

[23] McKinsey & Company, Global Investor Opinion Survey: Key Results. 2002, *available at* http://ww1.mckinsey.com/corporategovernance/PDF/GlobalInvestorOpinionSurvey2002.pdf

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when corporate governance standards, codes and rules vary from country to country?

In order to allow cross-country comparisons, a new corporate governance index developed by the Financial Times and Institutional Shareholder Services (ISS) limits the number of corporate governance factors to just five areas: board composition and independence; executive and director compensation; company ownership; audit independence; and takeover defences and shareholder rights. Based on the assessment of individual companies based on these criteria, the index then ranks countries according to the average governance ratings.

Exhibit 3. FTSE/ISS Pilot Corporate Governance Index

Rank	Country	No of Companies
1	United Kingdom	205
2	Australia	86
3	New Zealand	15
4	Ireland	14
5	Singapore	57
6	Canada	201
7	Sweden	46
8	Hong Kong	50
9	Finland	30
10	United States	470
11	Switzerland	61
12	Germany	90
13	Austria	23
14	France	90
15	Japan	501
16	Denmark	26
17	Italy	69
18	Spain	56
19	Belgium	24
20	Netherlands	56
21	Greece	48
22	Norway	21
23	Portugal	15

On the preliminary index, the UK scores best, followed by Australia and New Zealand (Exhibit 3). Interestingly, the UK and Australia are also perceived to enjoy the relatively best corporate governance macro framework. Overall, there is a relatively strong correlation between the average quality of corporate governance at

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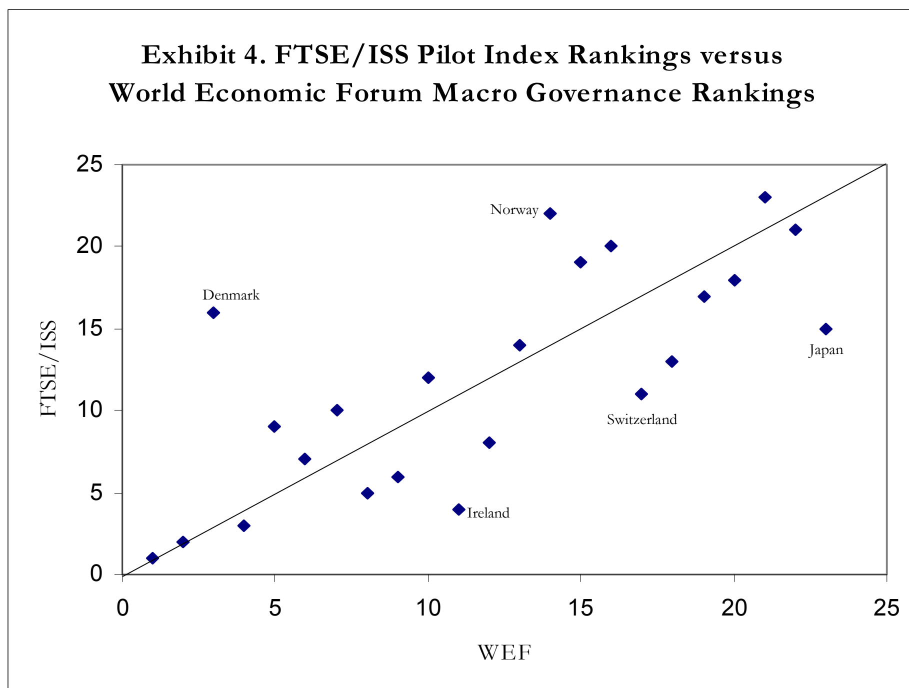
the company level and the perceived quality of the macro governance framework these companies operate in. (Exhibit 4). However, there are a number of important outliers. Japanese, Swiss, and Irish companies are found to employ better corporate governance practices than the perceived quality of their corporate governance standards at the country level would suggest. To a somewhat lesser extent, this also applies to companies in Austria, Canada, Hong Kong and Singapore. These companies may be called "overachievers."[24] For example, while Japanese companies are ranked 15th among the 23 countries considered here, the corporate governance framework in which they operate in is perceived to be the worst among all high-income countries.



Conversely, companies whose corporate governance practices are worse than the perceived quality of the corporate governance framework they operate in may be called "underachievers." Examples include in particular Danish and Norwegian companies. On the FTSE/ISS Pilot Index, Denmark is ranked 16th whereas the World Economic Forum's survey ranks Denmark's corporate governance quality as the third highest among all countries. Whereas Norwegian companies enjoy

[24] *See* Dallas, *supra* note 7, at 154.

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framework conditions that are ranked 14th according to the World Economic Forum's survey, the FTSE/ISS Pilot Index puts Norwegian companies at 22nd in terms of their own corporate governance practices. Other underachievers include US, Belgian and Dutch companies.

The World Economic Forum's executive survey also includes questions that focus on corporate governance practices at the company level, in addition to those that concentrate on the quality of corporate governance at the country level. Three questions are particularly relevant, dealing with corporate ethics, appointments of directors and insider control (Box 3). The survey results are shown in exhibit 5.

Box 3. GCR Survey questions on firm-level governance

The corporate ethics (ethical behavior in interactions with public officials, politicians, and other enterprises) of your country's firms in your industry are (1 = among the world's worst, 7 = among the world's best).

Senior management positions in your country are (1 = usually held by relatives, 7 = held by professional managers chosen based on superior qualification).

Corporate boards in your country are (1 = controlled by management, 7 = powerful and represent outside shareholders).

Several countries score well across the board, including the UK, Australia, and Finland. By contrast, considerable deficiencies are perceived to exist on average in Greek, Portuguese and Italian companies. Japanese companies score relatively well in terms of their reliance on professional management but are perceived to be considerably weaker with regard to the efficacy of their boards as well as their ethical behaviour. Most other countries cluster again in the 5 to 6 range on a 1 to 7 scale.

How do the World Economic Forum's survey results compare with the FTSE/ISS Pilot Index? While both approaches focus on corporate governance practices at the company level, the survey results reflect perceptions as opposed to measurable indicators employed by the FTSE/ISS index. Perhaps not surprisingly, there is a fairly strong correlation between the two measures, although important outliers exist (exhibit 6).

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Exhibit 5. Perceived Quality of Firm Level Corporate Governance

Country	Efficacy of Corporate Boards (1)	Ethical Behaviour of Firms (2)	Reliance on Professional Management (3)	Unweighted Average (1-3)
Australia	6.0	6.0	6.7	6.2
Austria	5.0	5.7	6.2	5.6
Belgium	5.2	5.5	5.8	5.5
Canada	5.5	5.9	6.0	5.8
Denmark	5.8	6.3	6.0	6.0
Finland	5.7	6.5	6.5	6.2
France	4.8	5.6	5.7	5.4
Germany	5.3	5.8	6.4	5.8
Greece	4.3	4.0	4.1	4.1
Hong Kong	4.7	5.2	5.0	5.0
Ireland	5.1	4.9	6.0	5.3
Italy	4.6	4.6	4.5	4.6
Japan	4.4	4.8	5.6	4.9
Netherlands	5.2	5.9	6.2	5.8
New Zealand	5.8	6.2	6.4	6.1
Norway	5.1	5.6	5.4	5.4
Portugal	4.2	4.6	4.9	4.6
Singapore	5.5	6.2	5.8	5.8
Spain	4.6	5.4	5.2	5.1
Sweden	5.3	6.1	6.5	6.0
Switzerland	5.0	5.8	5.7	5.5
UK	6.1	6.2	6.5	6.3
USA	5.8	5.8	6.3	6.0

In some cases, perceptions about corporate governance practices are considerably worse than what would the FTSE/ISS Pilot Index suggest. This applies especially to Ireland and Hong Kong but to a lesser degree also to Singapore, Japan, and Italy. Vice versa, there are a number of countries where the actual quality of corporate governance practices at the company level as assessed by the FTSE/ISS project appears worse than what survey respondents perceive. Finish, Danish and Dutch companies in particular receive considerably better marks from surveys compared with "hard" indicators. However, overall perceptions are largely in line with measurable indicators of corporate governance, although the focus of the two approaches is considerably different.

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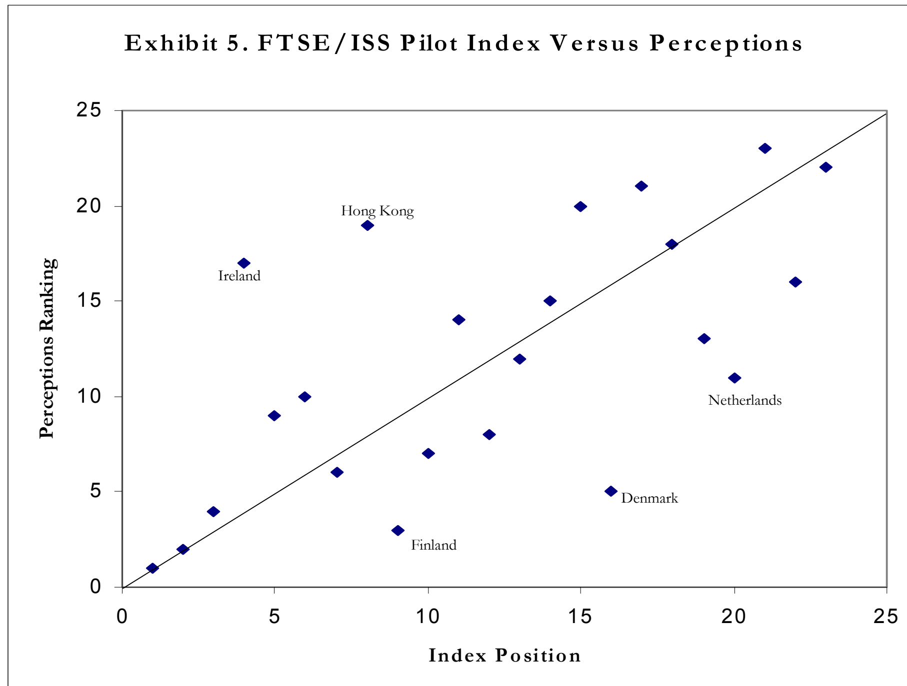

D. EU enlargement and corporate governance in the new member states

The quality of corporate governance may have an important effect on the mode of foreign investment. Firms are in themselves substitutes for the market and will extent their borders whenever they encounter missing or inefficient markets.[25] Foreign companies dealing with such markets will want to have hierarchical control in those environments where transaction costs are high due to inadequate contract enforcement, poor protection of property rights or inappropriate board procedures. Markets may be attractive for other reasons, for example, because of a rapidly expanding consumer base or natural resource endowments. But whereas a poor macroeconomic governance infrastructure may deter foreign investment altogether, weak corporate governance standards may discourage portfolio investors to a relatively larger extent. By comparison, foreign investors who acquire a controlling stake in a foreign company or undertake Greenfield investment tend to be less affected. A high share of foreign direct investment (FDI) may thus signal poor, rather than good, corporate governance.[26]

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[25] *See* O. WILLIAMSON ,THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985).

[26] *See* R. HAUSMANN, & E. FERNÁNDEZ-ARIAS, FOREIGN DIRECT INVESTMENT: GOOD CHOLESTEROL? (2000).

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This hypothesis has potentially important implications for emerging market economies, and in order to examine this hypothesis further, we look at the eight transition countries in Central and Eastern Europe, which joined the European Union in May 2004. Unfortunately, these countries are not (yet) included in the FTSE/ISS Pilot Index so that we do not have consistent information about the quality of corporate governance at the firm level across a sufficiently large sample of companies. In the absence of this information, we employ survey data from the World Economic Forum's Global Competitiveness Survey, reflecting the perceived quality of governance standards both at the national and company level.

As one might expect, the quality of corporate governance is generally perceived to be inferior compared with incumbent 15 EU states. This applies to both dimensions of corporate governance. Interestingly, the majority of the accession countries lie above the 45-degree line in exhibit 6, implying that the quality of corporate governance at the company level is usually perceived to be higher than the quality of the national governance framework. Perhaps with the exception of the Czech Republic, however, the difference does not seem to be large enough to expect companies to compensate investors for increased investment risk due to comparatively poor standards at the national level.

Most accession countries enjoy a relatively high share of portfolio-to FDI inflows – defined by a threshold of 20%. In terms of total capital inflows, this empirical observation appears to be inconsistent with the hypothesis that investors prefer FDI as a mode of entry in countries with relatively weak corporate governance standards. However, compared with other emerging market economies the new EU member states are perceived to enjoy relatively good framework conditions (exhibit 7). But more importantly perhaps, investors anticipate further improvements both at the national and company levels thanks to EU membership. As these countries upgrade their corporate governance standards, capital inflows are likely to continue to increase further, especially in the form of portfolio investment.

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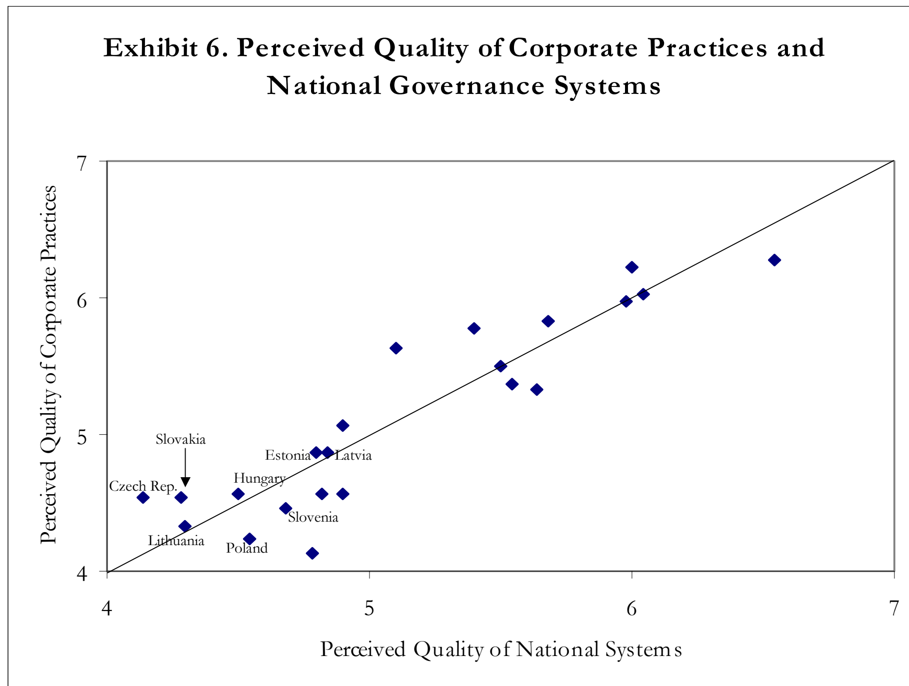

Exhibit 6. Perceived Quality of Corporate Practices and National Governance Systems

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Exhibit 7. Corporate Governance and Composition of Financial Flows

E. Conclusions

That good corporate governance can help create shareholder value is hardly disputed today. Motivated by numerous academic studies that showed that well governed companies tend to out perform others by a significant margin, many institutional investors have substantially upgraded their in-house research capabilities on corporate governance. At the same time, corporate governance has become an integral part of credit research by the leading ratings agencies, and the number of external consultants on corporate governance has risen noticeably.

Given that corporate governance matters regardless of the particular system – the legal and institutional framework conditions – investors have shown growing interest in a global benchmark of good behaviour. While much work has been done in benchmarking governance systems at the macroeconomic level, relatively little

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has been produced with regard to benchmarking corporate governance practices at the company level. And even less analysis is available at the interface of corporate governance at the country level and the company level. This is an important gap, for companies operating in weak country environments may transcend local practice.

This paper aims at contributing to fill the existing gap. In so doing, we focused primarily on 23 high-income countries. First, we looked at corporate governance systems as classified by the "law matters" school. We then juxtaposed various country-level measures based on this approach with new survey evidence from the World Economic Forum's Global Competitiveness Report regarding the quality of the legal and institutional framework in individual countries. In the second part of the paper, we focused on corporate governance at the company level, hypothesizing that good corporate practices are most valuable to investors where the disclosure and legal framework protecting shareholders is weakest. The starting point for our analysis was a new FTSE/ISS Pilot Index, which attempts to benchmark corporate governance at the company level. Ranking countries according to their companies' average scores, we then identified overachievers and underachievers in the sense that the quality of governance at the company level was better or worse than the quality of the legal and institutional framework these companies were operating in. We then employed survey data to examine the extent to which perceptions about the quality of corporate governance at the company level are consistent with measurable indicators. Finally, we looked at the transition economies that recently joined the EU and examined whether the perceived quality of their corporate governance standards is related to the composition of capital flows to these countries.

Three main conclusions emerge from our analysis First, although perceptions about the quality of corporate governance at the company level appear to be consistent with the propositions of the "law matters" school, other factors such as politics and cultural and historical roots seem to play an important role, too. Second, there is a relatively close correlation between the measured, as well as perceived quality of corporate governance at the country level and the company level. However, there exist important outliers. Importantly, there are several countries whose companies on average appear to follow better practices than the quality of their legal and regulatory environments would suggest. Good corporate governance at the company level may compensate for weak framework conditions, suggesting that a systems-focused view may lead to excessive risk aversion. Third, perceptions about the quality of corporate governance at the company level are largely in line with measurable indicators employed by the FTSE/ISS index, providing further support for the hypothesis that a company's governance practices need not be tied or constrained by its local environment.

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Although full convergence of corporate governance systems is neither likely nor desirable, given that these are rooted in a country's cultural and historical backgrounds and political conditions, globalization can be expected to lead to greater convergence of corporate governance practices. In the future, we may therefore expect a greater dispersion of the quality of corporate governance at the country level and at the company level. This appears especially relevant with regard to investing in emerging market economies, an issue we leave for future research.

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