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Corporate Governance and Financial Globalization

René M. Stulz *

In his recent book, Thomas L. Friedman makes the case that globalization leads to a flat world.¹ By that, he means that it removes obstacles that, in the past, would have prevented firms and individuals from competing with each other across the world. Such competition improves welfare not only by insuring that goods are produced at the lowest cost but also by making sure that consumers get access to new and better goods. Assuredly, the world is not flat yet. Nevertheless, the metaphor is helpful for understanding the forces that shape our world. It is even more apt to describe the financial world than the world of trade in goods. For many countries, the most significant explicit barriers to trade in financial assets have been knocked down.

In a paper with Andrew Karolyi, I describe how the financial world would look if it were flat.² The most striking counter-factual is that, despite the removal of barriers to trade in financial assets, capital does not flow to countries with low-capital stocks as strongly as one would expect.³ As Robert Lucas once pointed out forcefully, differences in the marginal product of capital between industrialized countries and emerging countries are large. In fact, over the recent past, capital has come rushing into the United States, when one would expect it instead to flow to emerging countries. Using data from the IMF, the cumulative sum of net equity flows to less developed countries

from 1996 to 2004 is a negative \$67.4 billion.

What then are the obstacles left that make the financial world full of ridges and mountains, so that capital does not flow where the physical marginal product of capital is highest? The answer is that poor corporate governance stands in the way of countries getting the full benefit of financial globalization. With poor governance, firms are valued less by the capital markets, so that entrepreneurs are more limited in their abilities to raise money to finance their activities. As a result, firms are smaller and growth is stymied.

An investment of \$100 might be more productive in Indonesia than in the United States, but the investment will not take place in Indonesia if investors expect to receive a higher return on their investment in the United States. Poor governance prevents investors from receiving the full return on their investment, because third parties pick off the fruits of those investments before they are received. For instance, controlling shareholders in a company in Indonesia might siphon off earnings for their own profit rather than using them to provide a return to outside investors.

As I emphasized in a paper with Craig Doidge and Karolyi, corporate governance has two dimensions.⁴ First, it has an external, country-level, dimension. The institutions of the country in which a firm is located affect how investors receive a return from investing in the firm. Perhaps most importantly, a country's laws specify the rights that investors have, and the enforcement of the laws determines the extent to which

these rights are meaningful. Second, corporate governance has an internal, firm-level, dimension. Firms can organize themselves so that they are well governed. For instance, they can commit themselves to good disclosure, which makes it harder for corporate insiders to take advantage of other investors. The quality of a firm's governance depends both on the quality of internal, firm-level, and external, country-level, governance. There has been considerable research on these two dimensions of governance in recent years. In the following paragraphs, I discuss some of the contributions I have made with my co-authors in examining the interaction between financial globalization and corporate governance.

Lee Pinkowitz, Craig Williamson, and I provide a useful way to understand the importance of the governance problem as an obstacle to financial globalization.⁵ One would expect, if governance works well, that a dollar of cash would be worth a dollar when the capital markets value a corporation. If a dollar of cash were worth less than a dollar, then it would mean that managers or controlling shareholders are wasting cash. We investigate how capital markets assess the value of cash in 35 countries from 1988 through 1998. Our sample includes more than 6,000 companies per year on average. We find that if we split the countries according to an index of corruption, the value of a dollar of cash is worth \$0.91 in countries with low corruption and \$0.33 in countries with high corruption. While the value of a dollar of cash inside the corporation is worth an amount not significantly different from \$1 in countries

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with low corruption, it is worth significantly less in countries with high corruption. How do we know that poor governance explains this result? We also find that dividends are worth a lot more in countries with high corruption than they are in countries with low corruption. In other words, investors value cash paid out by the corporation in countries with high corruption because they have good reasons to expect that cash kept within the firm will be wasted or stolen.

In the paper just discussed, we used country indices of governance. In other words, we classified as poor-governance countries those in which investors are poorly protected, so that they are less likely to receive a return on their investment. This focus raises the question of how important countries are for corporate governance. Could it be that firms can adopt good governance practices in countries that protect investors poorly so that they would be on a level playing field with firms from countries that protect investors well? It turns out that countries have a determinant influence on governance. Doidge, Karolyi, and I investigate three corporate governance rankings.⁶ One example of such rankings is S&P's Transparency and Disclosure ratings, which evaluate the disclosure practices of corporations in emerging and industrialized countries. We find that most of the variation in corporate governance rankings can be explained by country characteristics. In other words, for the corporate governance rankings we observe, just knowing a firm's country of origin explains most of the variation in rankings across firms.

An important question is why governance differs across countries. The literature has provided a number of hypotheses. La Porta et al. point to the importance of a country's legal origins.⁷ Johnson et al. focus on how a country's endowments shape its institutions.⁸

Rohan Williamson and I emphasize the importance of culture as a determinant of institutions. We show that a country's religion helps predict a country's shareholder rights, creditor rights, and enforcement of property rights. In particular, we find that protestant countries typically have much stronger creditor rights than catholic countries. In the paper with Doidge and Karolyi, I also show that a country's economic and financial development affect governance. At the firm level, good governance reduces a firm's cost of capital. This advantage is of limited use if capital markets are underdeveloped, however. Consequently, the incentives of firms and countries to invest in governance are limited when financial markets are poorly developed.

The evidence suggests that it is difficult for firms to find ways to offset the disadvantages resulting from being located in a country with poor institutions. However, I make the point that firms can rent institutions from countries with better institutions.⁹ In particular, foreign firms that list their shares in the United States benefit from some U.S. institutions. For instance, they have to meet various disclosure requirements that U.S. firms have to meet and their investors can use the U.S. courts and benefit from U.S. laws and regulations.

Doidge, Karolyi, and I examine whether the evidence is consistent with the hypothesis that firms cross-list in the United States to take advantage of the U.S. institutions that protect investors.¹⁰ We find strong support for this hypothesis. Our paper identifies a striking result, which we call the "listing premium." We find that foreign firms that list in the United States are worth substantially more than foreign firms that do not list in the United States. The paper examines the valuation of 712 cross-listed stocks and 4,078 non-cross-listed stocks in 1997. It finds that the valuation of cross-listed stocks were

worth 16.5 percent more on average than comparable firms that were not cross-listed. This cross-listing premium was even more dramatic for firms listed on NYSE, where it was 37 percent on average. In recent work, not yet circulating as a working paper, we show that this cross-listing premium persists through time.

In the United States and a few other countries, ownership of large corporations is dispersed. In contrast, in most other countries, ownership of large corporations is concentrated and corporations have controlling shareholders. This difference in how corporations are owned across the world has much to do with differences in governance. I show that ownership is much more concentrated in countries with high corruption.¹¹ The reason for this is straightforward. Everything else equal, insiders would rather diversify their wealth, so that concentrated ownership is costly for them. In countries with high corruption, it is easier for corporate insiders to steal from minority shareholders. However, when corporate insiders have a large stake in the corporation, they end up stealing mostly from themselves. If stealing from minority shareholders has costs for corporate insiders, less stealing takes place when corporate insiders have a larger stake in the corporation. Consequently, in countries where governance is poor, insiders have to co-invest more with other shareholders. Since the resources of insiders are limited, it follows that firms are smaller and more levered in countries where governance is poor.

The literature has shown that capital markets are weak when investors are poorly protected. In a paper with Jean Helwege and Christo Pirinsky, I show that capital markets play a key role in how U.S. companies evolve after their IPO so that their ownership becomes dispersed.¹² In that paper, we show that the corporations whose ownership

becomes dispersed quickly after their IPO benefit from a liquid market for their stock. In other words, ownership becomes dispersed only for the firms that benefit from a well-functioning market for their stock.

If the financial world were flat, we would expect investors to be more internationally diversified than they are. The home bias in equity holdings has garnered much attention from economists. Karolyi and I review much of the evidence on the home bias and report that it is still substantial.¹³ Magnus Dahlquist, Pinkowitz, Williamson, and I tie the home bias to governance.¹⁴ In small countries, foreign investors would hold most shares if the financial world were flat. We argue that a major reason why this is not the case is that in countries with poor governance, corporate insiders have to hold large stakes in their shares/firms. The shares that corporate insiders hold cannot be held by foreign investors. With this argument, there is an upper limit to the fraction of shares that can be held by foreign investors. This upper limit is inversely related to the quality of governance in a country.

If all countries had good governance, then firms could be held by diversified investors. Since firm size would not be limited in part by the

resources of the insiders, firms could be larger, more investment could take place, and consumption would be less volatile. Hence, good governance is the key to a flat financial world.

¹ Thomas L. Friedman, *The World is Flat*, New York, N.Y.: Farrar, Straus, and Giroux, 2005.

² G. A. Karolyi and R.M. Stulz, "Are Financial Assets Priced Locally or Globally?" NBER Working Paper No 8994, June 2002, and in *The Handbook of the Economics of Finance*, G. Constantinides, M. Harris, and R.M. Stulz, eds. Elsevier-North Holland, 2003.

³ For a review of issues concerning capital flows, see R.M. Stulz, "International Portfolio Flows and Security Markets", in *International Capital Flows*, M. Feldstein, ed. Chicago: University Chicago Press, 1999, pp. 257–93.

⁴ See C. Doidge, G. A. Karolyi, and R. M. Stulz, "Why Do Countries Matter so Much for Corporate Governance?" NBER Working Paper No. 10726, September 2004.

⁵ L. Pinkowitz, R. Williamson, and R. M. Stulz, "Does the Contribution of Corporate Cash Holdings and Dividends to Firm Value Depend on Governance? A Cross-Country Analysis," *Journal of Finance*, forthcoming. An earlier version was circulated as NBER Working Paper No. 10188, December 2003.

⁶ C. Doidge, G. A. Karolyi, and R. M. Stulz, "Why Do Countries Matter so Much for Corporate Governance?"

⁷ R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. W. Vishny, "Law And

Finance," NBER Working Paper No. 5661, July 1996, and *Journal of Political Economy*, 106 (6), December 1998, pp. 1113–55.

⁸ D. Acemoglu, S. Johnson, and J. A. Robinson, "The Colonial Origins Of Comparative Development: An Empirical Investigation," *American Economic Review*, 91(5), December 2001, pp. 1369–401.

⁹ R. M. Stulz, "Globalization, Corporate Finance, and the Cost of Capital," *Journal of Applied Corporate Finance*, 8 (3), Fall 1995, pp. 30–8. A longer version of the paper appeared as NBER Working Paper No. 7021, March 1999.

¹⁰ R.M. Stulz, C. Doidge, and G.A. Karolyi, "Why Are Foreign Firms Listed in the U.S. Worth More?" NBER Working Paper No. 8538, October 2001, and *Journal of Financial Economics*, 71(2), 2004, pp. 205–38.

¹¹ R.M. Stulz, "The Limits Of Financial Globalization," NBER Working Paper No. 11070, January 2005, and *Journal of Finance*, 60(4), 2005, pp. 1595–638.

¹² J. Helwege, C. Pirinsky, and R.M. Stulz, "Why Do Firms Become Widely Held? An Analysis of The Dynamics of Corporate Ownership," NBER Working Paper No. 11505, August 2005.

¹³ G. A. Karolyi and R.M. Stulz, "Are Financial Assets Priced Locally or Globally?"

¹⁴ R. M. Stulz, L. Pinkowitz, and R. Williamson, "Corporate Governance and the Home Bias," NBER Working Paper No. 8680, December 2001, and *Journal of Financial and Quantitative Analysis*, 38(1), 2003, pp. 87–110.