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## Institutions, corporate governance and firm performance

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## Chapter 11

# Institutions, Corporate Governance and Firm Performance

Jos Grazell

### 11.1. Introduction

In this chapter, the relation between institutions, corporate governance and firm performance is investigated. The emergence of corporate governance questions in the past decade results from accounting scandals in firms, unexpected value redistributions between investors, mismanagement, worker dismissals, excessive remuneration policies and unfair income distribution in general, etc. Hence, it can be expected that several stakeholders try to change the institutions and more specifically the polity. Corporate governance is defined as “a system of procedures and structures that is used to govern and control the firm, within a field of forces of involved stakeholders, with the goal to contribute to the utility of these stakeholders”. Evidently, corporate governance regulations, practices and codes are examples of institutions, as institutions are defined as: “A way of thought or action of some prevalence and permanence, which is embedded in the habits of a group or the customs of a people. Institutions fix the confines of and impose upon the activities of human beings (Hamilton, 1932: 84).”

Before we can investigate the relation between institutions, corporate governance and firm performance in more detail, several modes of thinking about institutions will be discussed in the next section. Sections 11.3 and 11.4 deal with the phenomena of corporate governance in general and the corporate governance code in the Netherlands, respectively. In Section 11.5, the relation between institutions, corporate governance and firm performance is discussed and Section 11.6 concludes this chapter.

### 11.2. Institutions

#### 11.2.1. *Institutional Economics*

Institutional economics specializes on the examination of institutions and institutional change. It is a complementary field to neoclassical economics that traditionally specializes

1 in the marginal analyses of choices of economic subjects and that has always ignored the  
2 role of institutions. Rutherford (1994) explains that there are two important strands in insti-  
3 tutional economics, namely old or original institutionalism (OI) and new institutionalism  
4 (NI). Both strands can be subdivided in two sub-streams. The OI has a Veblen-Ayres and  
5 a Commons wing, while the NI shows a neoclassical and an Austrian branch (from the  
6 Austrian school). The Veblen-Ayres variant of institutionalism concentrates on the distinc-  
7 tion between technology and institutions while the Commons branch concentrates around  
8 the notion of institutions evolving out of the resolution of conflicting interests. The neo-  
9 classical branch of NI explains institutions in terms of the maximizing behaviour of indi-  
10 vidual economic agents. Maximizing behaviour here means the conscious design of  
11 institutions. The Austrian variant focuses more narrowly on the spontaneous, invisible  
12 hand development of institutions out of individual action. Insights of the Commons vari-  
13 ant of OI, and the neoclassical and Austrian variant of NI will be used here to explain the  
14 institutional development around corporate governance practices in the sector of the pub-  
15 licly traded firms. In the approach of the Commons, the central idea is that out of scarcity  
16 conflicts of interest emerge and that the development of an institutionalized system of rules  
17 delivers a degree of order and certainty that is needed for productive efficiency  
18 (Rutherford, 1994: 101). The Commons does not provide any detailed analysis on how  
19 institutions evolve out of individual actions. To find an answer to this question, one could  
20 look at prominent modes of thinking in the strand of NI. One of these approaches in new  
21 institutional economics (the Austrian approach) explains the emergence of conventions  
22 and rules out of the interaction between economic agents. Spontaneously, invisible hand  
23 processes produce certain behavioural rules and with game theoretical analysis, it is pos-  
24 sible to demonstrate that these rules generated by interaction and adaptation form a Nash  
25 equilibrium or even an evolutionary stable strategy (Rutherford, 1994: 110). The other,  
26 neoclassical approach consists of a government that rationally designs a system of prop-  
27 erty rights, and a judicial system that sets and enforces fundamental rules that govern  
28 exchange. The state maximizes wealth by assigning property rights to individuals or by  
29 redefining the structure of these rights (Rutherford, 1994: 118). With regard to the role of  
30 the government in this political process, two opinions are distinguished: namely, the naïve  
31 theory and the interest group or rent-seeking theory. This interest group or rent-seeking  
32 theory focuses on the redistributive effects of changes in property rights (Rutherford, 1994:  
33 119). A group may invest resources in lobbying and in making political contributions in an  
34 attempt to gain a particular change in property rights in its members' favour. Changes in  
35 company law and the introduction of or changes in corporate governance codes are exam-  
36 ples of these changes in property rights.

37

### 38 *11.2.2. Economic and Non-economic Institutions*

39

40 According to Williamson (1998; 2000: 597), there are four levels of social analysis (see  
41 Table 11.1). The first level is the level of embeddedness. Here, one finds informal institu-  
42 tions, customs, traditions, norms, culture and religion. The second level is the institutional  
43 environment. The formal rules of the game, for instance property rights, are determined  
44 there in the judiciary world of a polity or government bureaucracy. The third level is the  
45 sphere of governance. There the play of the game takes place by contracting parties that

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Table 11.1: Embedding corporate governance in the economic theories.

|  | Level (L)   | Frequency of change:<br>(in years) | Purpose   |
|--|---|------------------------------------|---|
| L1: Social theory  | Embeddedness: informal institutions, customs, traditions, norms, culture and religion                                       | 100–1000                           | Often non-calculative, spontaneous                                |
| L2: Economics of property rights/positive political theory | Institutional environment: formal rules of the game, especially property rights (polity, judiciary, government bureaucracy) | 10–100                             | Get the institutional environment right (first order economizing) |
| L3: Transaction cost economics                             | Governance: play of the game, especially contract (aligning governance structures with transactions)                        | 1–10                               | Get the governance structures right (second order economizing)    |
| L4: Neoclassical economics/agency theory                   | Resource allocation, asset deployment and utility maximization: (prices and quantities, incentive alignment)                | Continuous                         | Get the marginal conditions right (third order economizing)       |

1 align governance structures with transactions. Finally, the fourth level of analysis looks at  
2 resource allocation, asset deployment and utility maximization. Marginal analysis of costs  
3 and benefits determines prices and quantities such that they align the incentives of the eco-  
4 nomic agents.

5 Another distinction Williamson (2002: 171) makes is the possibility at look to eco-  
6 nomic science from two different viewpoints: namely, economics as a science of choice  
7 and economics as a science of contract. Neoclassical economics is the science of choice  
8 and institutional economics is the science of contract. After that the science of contract is  
9 separated in public-ordering and private-ordering. The public-ordering domain looks at the  
10 rules of the game, and these are developed by and incorporated in political, legal and thus  
11 non-economic institutions. Politics is a structure of complex exchange among individuals,  
12 a structure within which persons seek to secure collectively their own privately defined  
13 objectives that cannot be efficiently secured through simple market exchanges (Buchanan,  
14 1987: 296). Private-ordering mechanisms are economic institutions that can also be split  
15 into two related branches. One branch concentrates on front-end incentive alignment  
16 (security design, formal agency theory and formal property rights theory) and the other  
17 branch highlights the governance of ongoing, back-end, contractual relations (contract  
18 implementation). The private-ordering arrangements or economic institutions are all situ-  
19 ated at the third level of social analysis, while the public-ordering mechanisms that con-  
20 tain the non-economic institutions are placed at level two of the social analysis framework.  
21 The investigation of these second-level institutions is concentrated in the field of constitu-  
22 tional economics. Traditional neoclassical economics can be characterized as a fourth-  
23 level type of analyses of economic problems.

24 With the help of the social analysis framework, we can explain that the neoclassical  
25 branch of NI has the opinion that levels three and two phenomena are deeply influenced  
26 by level four forces. OI also states that level one informal institutions determine the  
27 resource allocation and need satisfaction process of level four via economic and non-  
28 economic institutions. So the difference of opinion between the adherents of OI and NI is  
29 about the direction of causality between the distinguished levels in the social analysis  
30 framework.

31 The contractual relation between the firm and its stakeholders can be interpreted as a  
32 variation on a theme. In this theme one of the important concepts, namely general- or spe-  
33 cial-purpose technology, plays an important role via a measure of asset specificity. Also  
34 the safeguarding of specific investments measured by the magnitude of safeguards is incor-  
35 porated as an important concept to develop a simple contracting schema of governance  
36 mechanisms.

37 Williamson (2002: 182) suggests that in a situation where transactions make use of a  
38 general-purpose technology, the suitable solution is the unassisted market transaction. For  
39 parties who transact without safeguarding specific investments, a special-purpose technol-  
40 ogy is the optimal technology. In this case, contractual supports take the form of inter-firm  
41 contractual safeguards. Credible contracting is then the topical governance mechanism.  
42 However, if the contractual supports break down, then it is more efficient to take the trans-  
43 action out of the market and organize it internally. The general message of the transaction  
44 cost theory is: try markets, try hybrids and have recourse to the firm and its hierarchy, and  
45 internal organization only when all else fails. This insight can be applied to the relationship

1 of the firm with its sources of finance. In the situation of general-purpose technology, the  
2 capital suppliers and the firm can opt for debt contracts because the bankruptcy procedure  
3 gives the bondholders the possibility in the case of default to exercise their pre-emptive  
4 claims against the assets in question. Additional safeguards are not necessary here. If spe-  
5 cial-purpose technology is traded in the transaction then the capital suppliers and the firm  
6 should choose equity contracts. Still, if they do not want to be in a situation of unrelieved  
7 hazard then contractual support to the equity contracts is required. A safeguarding feature  
8 that arises in support of the contract for equity finance is the board of directors. This private-  
9 ordering institution can contribute to credible contracting between firm and shareholders.

10 Suppose that contractual support is given to the equity contract by the introduction of a  
11 board of directors which:

- 12 • is elected by the pro-rata votes of those who hold tradable shares,
- 13 • has the power to replace the management team,
- 14 • decides on management compensation,
- 15 • has access to internal performance measures on a timely basis,
- 16 • can authorize audits in depth for special follow-up purposes,
- 17 • is apprised of important investment and operating proposals before they are implemented,
- 18 • bears a decision review and monitoring relation to the firm's management.

19  
20 Consequently, the residual claimant status of the shareholders in both earnings and asset  
21 liquidation is brought into line with their residual and ultimate control rights. Hence, this  
22 construction reduces the cost of capital given the safeguards for the equity holders. If this  
23 board of directors is not strong enough to operate as a safeguard for the equity investors  
24 (as the required penalties, information disclosure and verification procedures) are not insti-  
25 tuted or enforceable, then this theory suggests integration of the capital suppliers with the  
26 firm under one hierarchy. If this solution is not applicable, the firm and its capital suppli-  
27 ers remain in a situation of unrelieved hazard. It is to be expected that the parties con-  
28 cerned, attempt to change the formal institutional rules (like property rights) such that they  
29 are able to protect their position and the unrelieved hazardous situation is cancelled. This  
30 situation will especially arise for specific-purpose transactions where credible contracting  
31 is not possible because of the uncooperative behaviour of one or more involved stake-  
32 holders. Examples of changes in formal institutions are changes in company law and the  
33 introduction of corporate governance codes. The emergence of these institutional changes  
34 via a spontaneous process of stakeholders or via the conscious design of the government  
35 under political pressure are captured by the theories of the new institutional economists of  
36 the Austrian and the neoclassical wing, respectively.

### 37 38 39 **11.3. Corporate Governance**

#### 40 41 *11.3.1. Introduction*

42  
43 In the previous section, we have defined corporate governance as “a system of procedures  
44 and structures that is used to govern and control the firm, within a field of forces of  
45 involved stakeholders with the goal to contribute to the utility of these stakeholders”. This

1 field of forces contains the mutual monitoring and disciplining of stakeholders to look after  
2 the fulfilment of the agreements that were made about achievements and remuneration of  
3 each party. Characteristic for these agreements (are shaped in a nexus of contracts) is that  
4 employees and bondholders generally have fixed compensation, managers have fixed and  
5 variable components in their remuneration, and shareholders are entitled to the residual  
6 cash flow rights. Rent-seeking behaviour is the behaviour of economic agents who try to  
7 appropriate a larger compensation in comparison to their achievements than is agreed on  
8 when the contract was negotiated with the firm. The stakeholder that is best positioned to  
9 expropriate the wealth of the firm is the management team, because of its informational  
10 advantage. The employees and their unions try to protect themselves by asking for job and  
11 income security, bondholders want capital protection and little bankruptcy risk, and share-  
12 holders require a rate of return that compensates their exposure to fluctuating cash flows.  
13 All these monitoring and disciplining activities ask for institutions that enable these activ-  
14 ities and contribute to the utility of the stakeholders. The institutions that facilitate  
15 employee and investor protection can emerge either from spontaneous, invisible hand  
16 processes via markets and contracts, or they can be designed by a government that changes  
17 the property rights under the influence of lobbying activities of interest groups in political  
18 processes.

19 Rent appropriation and rent expropriation are a demonstration of principal-agent prob-  
20 lems that can exist between managers and shareholders, between majority, controlling  
21 shareholders and minority shareholders, between shareholders and bondholders, and  
22 between the employing firm and its employees. If the residual cash flow rights and the  
23 residual control rights are not distributed symmetrically between shareholders and man-  
24 agement, then there is an important source for an agency problem between these two stake-  
25 holders. This rent extraction problem is the basis for the definition of corporate governance  
26 by Shleifer and Vishny (1997: 737): "Corporate governance deals with the ways in which  
27 suppliers of finance to corporations assure themselves of getting a return on their invest-  
28 ment." And they add several questions to this definition like: "How do the suppliers of  
29 finance get managers to return some of the profits to them? How do they make sure that  
30 managers do not steal the capital they supply or invest it in bad projects? How do suppli-  
31 ers of finance control managers?" Also Shleifer and Vishny state that corporate governance  
32 mechanisms are economic and legal institutions that can be altered through the political  
33 process. Through private- or public-ordering arrangements, stakeholders intend to get a  
34 fair return on invested capital.

### 35 36 ***11.3.2. The Structure and Evolution of Corporate Governance***

37  
38 Corporate governance is an institutional arrangement that organizes the disciplining and  
39 monitoring mechanism within the firm (Table 11.2). This mechanism can be separated in  
40 an internal and an external disciplining mechanism and you can divide the system of pro-  
41 cedures and structures in three aspects: namely, in a legal, an economic and a social angle.

42 The corporate governance mechanism is a safeguard mechanism in addition to the  
43 equity contract, which makes it for equity holders better possible to earn a return on their  
44 investment. We can conclude that the managerial power position has increased substan-  
45 tially during the last decade because this group was able to increase its remuneration level

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Table 11.2: Corporate governance disciplining mechanisms.

|   | Legal  | Economic   | Social  |
|---|--|--|---|
| System of procedures and structures:(→) |  |  |   |
| Disciplining mechanisms:(↓)             |  |  |   |
| Internal                                | Board of directors<br>General meeting of shareholders<br>Work council                                    | Remuneration structure<br>Composition board of directors:<br>Executives and non-executives<br>Internal labour market<br>Ownership structure<br>Control structure | Internal behaviour codes<br>Board of directors:<br>• Remuneration committee<br>• Nomination committee<br>• Audit committee<br>• Strategy committee<br>Corporate culture |
| External                                | Structure regime<br>Listing requirements<br>Corporate law<br>Disclosure act<br>Corporate governance code | Capital market<br>Take over market<br>Purchasing market<br>Sales market<br>External labour market  | Corporate governance committee<br>Associations of investors, firms<br>Monitoring authorities<br>Political process<br>Culture society                                    |



1 substantially in a lot of countries with very much different characteristics. Due to the  
2 increased power position in management teams, one can expect a counter reaction by  
3 equity investors, creditors, employees and other stakeholders by putting more efforts in  
4 disciplining and monitoring activities, by renegotiating contracts and by bringing this topic  
5 in the political process. This conflict of interest around the remuneration of managers  
6 directed us to a situation where the control rights shifted more in the direction of the share-  
7 holders. Another development is the increase in the concentration degree of the ownership  
8 structure of firms. Large shareholders are better equipped to monitor firms than a large  
9 group of small shareholders. The disadvantage of the emergence of large shareholders is  
10 that this type of shareholder can expropriate minority shareholders. So, one agency prob-  
11 lem is solved by the introduction of another one. That is a frequently returning dilemma in  
12 the world of corporate governance. Also, more and more objections against the use of dual-  
13 class shares, pyramid/cascade structures in ownership structures and crossholdings which  
14 take away the control rights from the shareholder and put it in the hands of management  
15 teams which are more entrenched in this way.

16 Due to this conflict around executive remuneration we register a shift from manage-  
17 ment-controlled firms to more owner-controlled firms (Grazell, 1992; 1997). The con-  
18 tractual safeguards that support the equity contracts are not sufficient to redress the  
19 increased rent extraction effort by the management teams. In many countries, political  
20 means are used to try to change the public-ordering mechanism that organizes the rela-  
21 tion between the firm and its stakeholders. Proposals from interest groups have arisen to  
22 create corporate governance committees, which consist of representatives of the most  
23 important stakeholders. In these corporate governance committees negotiations take place  
24 between the several stakeholders of the firms and the compromises are moulded in codes  
25 of best practice. Even the status of these corporate governance codes is a topic of discus-  
26 sion. Sometimes these corporate governance codes are incorporated in company law,  
27 sometimes these codes get a semi-public status and are not enforceable because firms  
28 only had to follow the “comply or explain principle”. This depended for instance on the  
29 legal tradition in these countries. So during a decade of increasing conflict around man-  
30 agement remuneration, we witness the development of and the dynamic interaction  
31 between private-ordering mechanisms and public-ordering mechanisms to solve the var-  
32 ious agency problems.

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### 34 ***11.3.3. The Scandals***

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36 The increasing conflict around executive compensation was not the only problem that  
37 drew the attention of the public. There were also a number of striking scandals in the busi-  
38 ness world: Maxwell Corporation (1991), Enron (2001), Parmalat (2003) and Ahold  
39 (2003). All these scandals were characterized by fraudulent activities of executives who  
40 cumulated too many functions within one person. Especially the combination of execu-  
41 tive tasks and supervision tasks or even the combination of executive and financial man-  
42 agement tasks were unacceptable practices which brought managers at the top into  
43 temptation to act without honesty and integrity. Managers who noticed that they could not  
44 meet their too ambitious targets searched for escape routes and found these routes in  
45 fraudulent activities in their financial reporting systems. All these scandals were similar

1 in this sense that auditors failed to pick up the fraud. Auditing functions and executive  
2 tasks were not separated from each other. These scandals were triggers to start an inten-  
3 sive societal debate in a lot of countries on corporate governance practices. This gave an  
4 impulse to the design of additional public-ordering devices.  
5

#### 6 ***11.3.4. The Development of Codes Around the World*** 7

8 The corporate scandals and fraudulent accounting practices combined with the debates  
9 about managerial remuneration led governments and regulators to introduce stronger regu-  
10 lation to reinforce investor confidence in the financial markets. In some countries, legisla-  
11 tion and codes addressing corporate governance problems have been in existence for  
12 decades, in others governments are just embarking on the development of these codes. In  
13 the Anglo-Saxon world the Cadbury report (1992) was one of the first codes of best prac-  
14 tice with recommendations on a range of governance practices like the structure and com-  
15 position of the board of directors and the board committees, and highlighted the importance  
16 of non-executive directors (Maier, 2005: 3). Reason for the development of this code was  
17 the collapse of the Maxwell Publishing Group. The “comply or explain principle” was  
18 established in this code. Other codes were added which resulted in the Combined Code  
19 (1998; 2003).

20 Due to the Enron and WorldCom scandals in the USA, reforms were agreed by the US  
21 Congress and the New York Stock Exchange (NYSE). The result was the introduction of  
22 the Accounting Industry Reform Act 2002, widely known as the Sarbanes-Oxley Act, and  
23 the insertion of corporate governance rules in the listing requirements of the NYSE (Maier,  
24 2005: 4).

25 Major corporate scandals, and regulatory and legislative responses from governments  
26 and regulators are felt worldwide. The principles of good governance that all countries try  
27 to develop for their situation converge after a certain time to a kind of standard corporate  
28 governance code, which starts to function as a benchmark. The Organization of Economic  
29 Cooperation and Development (OECD) took the initiative to summarize all these princi-  
30 ples in an OECD Code of Principles of Corporate Governance (1999, 2004). Corporate  
31 governance codes address a wide range of structural and behavioural elements, including  
32 board accountability, shareholder rights, financial disclosure and internal controls, execu-  
33 tive remuneration, and board structure and functioning. The principles of the OECD incor-  
34 porate all these elements are non-binding but represent common corporate governance  
35 standards of good practice, intended to reflect and inform the corporate governance debate  
36 internationally. The principles cover the following issues:

- 37
- 38 • the basis for an effective corporate governance framework,
  - 39 • the rights of shareholders and key ownership functions,
  - 40 • the equitable treatment of shareholders,
  - 41 • the role of the stakeholders in corporate governance,
  - 42 • disclosure and transparency,
  - 43 • the responsibilities of the board.

44 Rather than advocating particular structures or types of behaviour, the principles identify  
45 common elements that underlie good corporate governance everywhere (Maier, 2005: 5).

### 1 **11.3.5. The Role of Investors**

2  
3 Although the development of a good corporate governance framework as a safeguard to  
4 the equity contract is of vital importance the behaviour of the actors itself and the way they  
5 fulfil their role cannot be neglected because only the combination of institutions and  
6 behaviour makes good governance practices possible. This issue is known in social theory  
7 as the agency structure problem (Hodgson, 2004; Scott, 1995). The institutions are the  
8 structure within which actors can fill in their actions. These structures constrain but also  
9 enable the actions the agent can choose. The principal-agent problem in economic theory  
10 is a problem within the agency structure firmament. A good corporate governance struc-  
11 ture demands within the possibilities of the agency structure framework from investors as  
12 well as managers an active attitude towards their task. From investors is expected that they  
13 are active monitors of the firm and that they exhaust every possibility to monitor their com-  
14 pany. Especially the large institutional investors have a responsible role to play, because  
15 they manage the wealth of millions of stakeholders. From managers a high ethical stan-  
16 dard is expected. Only then the residual loss (Jensen & Meckling, 1976) will be limited to  
17 a minimum and the trust and confidence in the good working of the institutions of society,  
18 that was shaken by the scandals, can be restored.

## 21 **11.4. Corporate Governance in the Netherlands**

22  
23 In the second half of the 1990s, the Dutch business community felt the need to institute a  
24 code of best practice in the field of corporate governance. In 1997, the Committee  
25 Corporate Governance produced a report with 40 recommendations. In 2002, a follow-up  
26 report was published that reflected the current state of affairs with respect to corporate  
27 governance reforms implemented in the Dutch business environment during the earlier  
28 5 years.

29 In December 2003, a newly installed Corporate Governance Committee published the  
30 final Dutch corporate governance code containing principles of good corporate governance  
31 and best practice provisions.

### 33 **11.4.1. Control Issues and Defensive Measures**

34  
35 Dutch listed companies are traditionally well protected against (hostile) takeovers. Since  
36 the beginning of the 1990s, however, this protection has been under attack. In 1997, a bill  
37 to restrict these measures was sent to parliament, but never became law. At present, a new  
38 bill is being prepared, with a view to implementing the 13th European Union (EU)  
39 Directive on takeovers. In addition to the pressure coming from the new legislation, Dutch  
40 employers are also calling for the dismantling of defensive measures against takeovers.  
41 The debate has focused on the extent to which defensive measures should be allowed. In  
42 the listing requirements of the Euronext Stock Exchange Amsterdam, a rule is included  
43 which limits firms to accumulate defensive measures. Since 1992, firms are not allowed to  
44 have more than two of these anti-takeover devices.

#### 1 **11.4.2. The Two-Tier Structure Reform Act of 2004**

2  
3 According to the Dutch Civil Code, a statutory two-tier regime exists in the Netherlands  
4 since 1971, consists of a system in which the supervisory board appoints its own members.  
5 At the beginning of the 1990s, this issue was readdressed by several stakeholders such as  
6 the Dutch Investors' Association. After advice of the Social Economic Council the Dutch  
7 Government decided to change the law by introducing the Two-Tier Structure Reform Act  
8 of 2004. The main characteristics of this Act are that the powers of the works council have  
9 been altered by an increased right of recommendation and the disappearance of the right  
10 to object to certain candidates for the nomination of supervisory board members. In addition,  
11 the general meeting of shareholders has been granted the right:

- 12  
13 • to appoint the members of the supervisory board,  
14 • to reject any nomination for the appointment of supervisory directors,  
15 • to dismiss the entire supervisory board.

16 The Two-tier Structure Reform Act came into effect on 1st September, 2004, and will  
17 have an important impact on the Dutch corporate governance culture (Groenewald, 2005:  
18 297–300).

#### 19 20 **11.4.3. The Dutch Corporate Governance Code**

21  
22 The Code contains five chapters with principles and best practices on the role of the man-  
23 aging board, the supervisory board, the shareholders, the general meeting of shareholders,  
24 and the internal and the external auditors. One of the provisions on the managing board is  
25 that they are appointed for a maximum of 4 years and that they cannot be tenured employ-  
26 ees. There are also restrictions on remuneration (such as the conditional grants of stock  
27 options to managing directors). The maximum severance pay in the event of dismissal of  
28 a managing director is equal to 1 year's salary. With the exception of one supervisory  
29 director, all supervisory directors have to be independent. Detailed criteria to ensure such  
30 independency are described in the code. The supervisory board will appoint an audit com-  
31 mittee, a remuneration committee and a nomination committee. The chairman of the  
32 supervisory board will be responsible for the proper functioning of the supervisory board  
33 and its committees.

34 The shareholders can play a role in decisions affecting the identity of the company or  
35 concerning large acquisitions and divestments. Depository receipts for shares will no  
36 longer able to be used as anti-takeover mechanism. Proxy voting and proxy solicitation  
37 will be facilitated. Equal treatment of all shareholders will be secured in the informational  
38 contacts of firms with the financial markets. An external auditor is appointed by the gen-  
39 eral meeting of shareholders on the recommendation of the supervisory board. The audit  
40 committee assesses how the external auditor is engaged in the content and publication of  
41 financial information. Apart from the external auditor, the internal auditor will work under  
42 the responsibility of the managing board. The managing board and supervisory board are  
43 together responsible for the company's corporate governance structure and the company's  
44 compliance with the code. The annual report should explicitly state whether the company  
45

1 complies with the code and, if it does not, the reasons for its non-compliance (Groenewald,  
2 2005: 301–305).

3 The “apply or explain” provision has been given a legal basis in the Two-Tier Structure  
4 Reform Act of 2004. The enforcement of the “apply or explain” principle will not take  
5 place exclusively in the annual report but may also be achieved by an inquiry before the  
6 Enterprise Chamber of the Supreme Court into the affairs of the company in the event of  
7 an infringement of the code’s provisions. In that case, both the managing board and the  
8 supervisory board may be held liable for improper management and may be held person-  
9 ally responsible. Even though the code is meant to apply exclusively to listed companies  
10 the corporate governance committee has stated that the principles may also be relevant for  
11 large non-listed companies (Groenewald, 2005: 307–309).

### 12 13 14 **11.5. Institutions and Corporate Governance Practices as a** 15 **Determinant of Firm Performance** 16

17 Firm performance can be measured in diverse ways: accounting returns or market-to-book  
18 ratios ( $q$ -ratios). We can distinguish three strands of theory by type of firm activity.  
19 Information theories state that investments in new technology benefit from the existence  
20 of securities markets while traditional investments benefit from the monitoring that banks  
21 can provide. In commitment theories, concentrated ownership is associated with activities  
22 that involve also investments by stakeholders other than the investors, and dispersed own-  
23 ership is optimal in investments in new technologies. In control theories, long-term invest-  
24 ments are more promoted in concentrated banking systems, while short-term investments  
25 are financed in systems with fragmented banking relations. High-risk R&D investments  
26 are financed by dispersed ownership systems and lower-risk, and more imitative invest-  
27 ments with concentrated ownership systems (Mayer, 2002: 314–315).

28 The relation between investor protection and corporate valuation is investigated by La  
29 Porta, Lopez-de-Silanes, Shleifer, and Vishny (2002). They find that poor shareholder pro-  
30 tection is penalized with lower valuations and that higher cash flow ownership by the con-  
31 trolling shareholder improves valuation especially in countries with poor investor  
32 protection. Investor protection can be regulated in a code (civil) law system and in a com-  
33 mon law system. Code law is according to the concepts of Williamson (2002) a public-  
34 ordering device and common law, a private-ordering mechanism. La Porta,  
35 Lopez-de-Silanes, Shleifer, and Vishny (2002) find in their study that in countries with  
36 common law systems Tobin’s  $q$  is significantly higher than in countries with civil law sys-  
37 tems. Also, the anti-director rights are significantly higher in common law countries. La  
38 Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) distinguish three legal traditions,  
39 namely the French, the German and the Scandinavian. Common law countries have the  
40 strongest protection of outside investors via the enforcement of private contracts through  
41 the court system. Financial markets do not require regulation as long as the contracts are  
42 enforced. In many countries such enforcements cannot be taken for granted. In that case,  
43 other forms of protecting property rights are considered, such as judicial-enforced laws or  
44 even government-enforced regulations because they may be more efficient. At that  
45 moment, the country shifts to a code or civil law system. The French civil law countries

1 have the weakest protection for both shareholders and creditors. German civil law and  
2 Scandinavian countries fall in between, although they have stronger protection for credi-  
3 tors (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000: 7–8). Remarkable is that the  
4 emergence of corporate governance codes takes place in all the countries of the diverse law  
5 traditions but that it is to be expected that in the civil law countries the principles of these  
6 codes will be integrated in the law itself while in the more common-law-oriented countries  
7 the codes play a supportive role in the financial contracts. Whether contracts, court-  
8 enforced legal rules or government-enforced regulations are the most efficient form of pro-  
9 tecting financial arrangements is largely an empirical question and depends on asset  
10 specificity. The consequences of better investor protection are that more dispersed owner-  
11 ship of shares is possible and that the fundamental agency problem between outside  
12 investors and controlling shareholders is solved. The existence of controlling shareholders  
13 mitigates also the Berle and Means variant of agency problems between outside investors  
14 and managers. These equilibrium ownership structures facilitate certain investment poli-  
15 cies as we saw earlier in this paragraph when we studied types of activities.

16 High investor protection encourages also the development of financial markets. When  
17 investors are protected from expropriation, the cost of capital decrease, making it more  
18 attractive for entrepreneurs to issue securities.

19 Financial development accelerates economic growth in three ways. First, it increases sav-  
20 ings. Second, it fosters through real investment capital accumulation. Third, to the extent that  
21 the financiers exercise control over the investment decisions, financial development allows  
22 capital to flow towards the more profitable and productive uses, and thus improves the  
23 resource allocation (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000: 13–17). Carlin  
24 and Mayer (2003) report a strong relation of information disclosure, fragmentation of bank-  
25 ing systems and concentration of ownership with the growth of equity-financed and skill-  
26 intensive industries. The growth of equity-dependent industries is particularly high in  
27 advanced countries with good information disclosure, investor protection and dispersed  
28 banking systems. Gugler (2001: 201–205) reports that direct shareholder monitoring has a  
29 positive impact on corporate performance. Large shareholders are active monitors in the cor-  
30 porations they control. They have both the incentives and the means to discipline manage-  
31 ment. Some studies do report beneficial effects of large shareholder monitoring for firm  
32 performance, but there are also some that find insignificant or unclear results. This result  
33 from the fact that large shareholders are not only effective monitors but also consume pri-  
34 vate benefits from control at the cost of minority shareholders. Institutional structure does  
35 not always mitigate this problem. The conflict between managers and owners, and between  
36 controlling shareholders and minority shareholders will only grow in importance. That is  
37 why institutional investors like pension funds or mutual funds will play a key role in chan-  
38 nelling private savings to productive investment. Efficient allocation processes will be stim-  
39 ulated thanks to these institutional investors by the successful implementation of good  
40 governance practices on the European financial markets. An important finding is that all con-  
41 stellations of ownership and control structure (Scott, 1997: 56) involve costs and benefits.  
42 Relying on one or a few tools to solve agency conflicts is not optimal. Sole reliance on one  
43 mechanism is not optimal but the right mix of direct monitoring by shareholders and board  
44 of directors, efficiently designed managerial compensation packages and tight competition  
45 in the managerial and product markets yields a better solution (Gugler, 2001: 204–205).



1 Corporate governance regulation and other legislation are intimately linked to each other.  
 2 Anti-trust policy, competition policy and regulations about corporate governance influence  
 3 each other and must be viewed in conjunction. If competition in product markets is weak,  
 4 managerial discretion over free cash flows is more likely to emerge and corporate gover-  
 5 nance practices become more important in monopolistic or oligopolistic environments.  
 6 Since monitoring is a public good in dispersed ownership structures, a carefully composed  
 7 mix of additional corporate governance means (like monitoring management by board of  
 8 directors, efficient remuneration contracts, well-functioning takeover markets and clear cor-  
 9 porate governance codes) to the individual equity contract is needed. All these services  
 10 together improve the performance of firms in a lot of countries (Gugler, 2001: 205–212).

## 11.6. Conclusions

15 The emergence of corporate governance codes is an important institutional element in a  
 16 lot of countries and contributes significantly to protection of investors. In civil law coun-  
 17 tries these codes are public-ordering mechanisms which operate like court-enforced legal  
 18 rules or government-enforced regulations contract, whereas in common law countries it  
 19 functions as a private-ordering mechanism that is a contractual safeguard to the equity  
 20 contract. This encourages the transparency and development of financial markets,  
 21 increases savings and real investment, and improves the resource allocation and the accu-  
 22 mulation of capital. Still, the introduction of these codes imposes transaction costs on  
 23 firms, which have to comply to all these rules. The frauds and scandals destroyed an  
 24 important component of immaterial capital namely trust. To rebuild an informal institu-  
 25 tion like trust between parties on the financial markets will take a lot of time and in the  
 26 mean time societies have to invest more means in investor protection so that the efficient  
 27 allocation of savings to the most profitable investment is guaranteed. The disappearance  
 28 of an informal institution like trust consequently has severe effects on the development of  
 29 formal institutions and the transaction costs in the financial system. The topicality of this  
 30 causal direction today makes that it is still possible to gain additional insights from the old  
 31 institutional economists.

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