

Analisi d'opera*

ROE M., *Political Determinants of Corporate Governance. Political Context, Corporate Impact*, Oxford, Oxford University Press, 2003.

1. - The Topic

In the last 10-15 years new theoretical and empirical analyses have been developed comparing the characteristics of different governance systems. Most researchers and international institutions agree that corporate governance is an institution that's central to wealth creation and growth and that its failures may significantly damage opportunities for development: the OECD has updated and enlarged its Principles of Corporate Governance to account for the differences across various systems; the World Bank report on Building Institutions for Markets devotes a chapter on corporate governance¹. Moreover, the recent crises of large companies have shown the negative effects of a poor governance.

Substantial advances have been obtained on the empirical side due to the larger availability of datasets, even if they still refer only to listed companies. The comparisons now give us richer pictures of the different systems and a more textured classification with respect to the traditional "market based vs bank based"² or "outsider vs insider"³ juxtapositions. Rather, the comparisons are now performed on the basis of characteristics of the governance structures, such as the concentration of ownership, the identity of the owners, the degree of separation between ownership and control, the instruments

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¹ See WORLD BANK (2002).

² See BERGLÖF E. (1990).

³ See FRANKS J. - MAYER C. (1997).

*used to obtain this separation, and the mechanisms adopted to reduce the agency problems*⁴.

More recently a literature is developing on what «determines» these differences and on their effects on performance. Roe's book is mainly concerned with the first question, but, indirectly, it might have something to say also on the second.

2. - The Corporate Governance Problem

*A good corporate governance system should satisfy two conditions. The first is to "efficiently allocate control", which implies that control of a company should be attributed to the most efficient agent and re-allocated whenever s/he is not longer adequate. The second is a "financing condition", and it implies that entrepreneurs' ideas and ability should be matched with the resources provided by investors, allowing the expansion of the firm beyond the funds available to the controlling agent: under this respect efficient mechanisms of governance should allow some separation between ownership (the funds) and control (the entrepreneurial activity), ensuring firms' growth. They do so by reducing the agency problems that separation typically generates, which basically amount to the possibility that users of capital "steal" the funds, invest them in bad projects, or consume perquisites*⁵. *This is obtained by providing sufficient guarantees to investors without limiting excessively the entrepreneurial freedom of the controlling agent.*

The first condition (efficient allocation of control) is essentially a dynamic condition and it is extremely difficult to evaluate whether and how it is satisfied. Most of the literature deals with how the second condition is satisfied, i.e. with "how" separation is obtained.

Separation may be achieved through various instruments. One possibility is that of family relations among controlling agents and financiers: this allows the firms to obtain funds beyond those of the

⁴ See, for example, LA PORTA R. *et AL.* (1999); CLAESSENS S. *et AL.* (2000); FACIO M. - LANG L.H.P. (2002); BARCA F. - BECHT M. (2001).

⁵ See for example BARCA F. (1994), SHLEIFER A. - VISHNY R. (1997).

entrepreneur, but has obvious limits and allows little separation. An extension to this is to obtain funds from a coalition of individuals. A different class of instruments that allow a higher degree of separation is represented by groups (mainly pyramidal), and contractual and statutory instruments (dual class shares, voting caps...). A pyramidal group allows an entrepreneur to control a vast amount of resources with a limited availability of funds through a chain of companies. Dual class shares allow to separate voting rights from cash flow rights, ensuring that the entrepreneur maintain the controlling power with a limited amount of resources. This group of instruments is more common in European continental (and developing countries). A second type of instrument to achieve separation is represented by a dispersed ownership. In a public company, control is exercised by an agent who typically owns a very limited share (possibly equal to zero) of a company. It is more common in Anglo-Saxon countries.

They pose agency costs of a different nature and degree. For example, in pyramidal groups and with contractual instruments, the main sources of agency problems are typically the private benefits of control enjoyed by controlling agents (e.g., the possibility to transfer resources at prices different from those prevailing on the market). In dispersed ownership structures the problems might be both private benefits and managerial agency costs (e.g., consumption of perquisites, excessive expansion of companies, entrenchment in the job).

The remedies to these problems are typically represented by a combination of various instruments and differ according to the source of separation. An effective instrument to reduce all kinds of agency problems would be the discipline imposed by the product market: the more competitive is the product market, the fewer are the rents that can be obtained by the controlling agent and hence that can be diverted. However it is difficult that this condition is perfectly verified in actual markets. A second important mechanism is an efficient market for corporate control; this should ensure that both the conditions described above are verified: i.e., that control is re-allocated when it is necessary and that this threat reduces the agency costs of separation; however a market for corporate control exists

only when ownership is not excessively concentrated, i.e. when control can be transferred against the will of the incumbent. A third mechanism to reduce agency costs is represented by the supervision by some "relevant" agents: these may be independent board members and/or large investors, e.g., banks or institutional investors. A further instrument is represented by rules regarding the fiduciary duties of managers and board members towards shareholders.

For these instruments to be effective, the correct incentives must be at work and possibly sanctions for deviations from the correct behaviour must be imposed. In particular, for the market for corporate control to work, sufficient and reliable information must be available for the market to react adequately; excessive defences for the controlling agents must not be available; the concentration of voting rights must not be too high. For agents such as independent directors or large investors to perform their expected role, they have to have the correct incentives: for example, it is not obvious whether independent directors have incentives — other than reputational — to exercise an intense monitoring. Some other agents (e.g., banks) may be subject to conflicts of interest. Fiduciary duties (whose strength varies in different countries) need to be efficiently enforced. For these reasons there is no clear ranking of corporate governance systems and this is possibly one of the reasons why we do not observe yet a clear convergence of models.

Hence we have systems with extremely concentrated ownership (continental countries) and systems where ownership is dispersed (Anglo-Saxon countries); countries where financial companies are among the main shareholders (e.g., Germany, with banks or the UK, with institutional investors) and others where non financial companies are (e.g., Italy, Spain, Belgium, France); countries where a market for corporate control exist (e.g., UK and US) and others where it doesn't and other instruments prevail.

3. - What Determines Different Governance Structures?

But even if there is no clear superiority of one model, what has produced these differences? Recently a relatively vast literature has

developed on the determinants of corporate governance structures. The different theses can be summarised in the following way.

(i) *A number of studies (mainly empirical) by La Porta et Al.⁶ (as is common now, we will cite them as LLSV) aimed at showing that the “quality” of corporate law affects corporate governance. More precisely, both the characteristics of the various “relevant” provisions in the law (i.e., relating to investor protection in corporate law and creditor powers in bankruptcy procedures) and the degree of enforcement of these laws influence the concentration of ownership (and hence the separation between ownership and control) and the amount of external finance (equity and debt) that firms can raise. The authors deduce from their international comparisons and empirical analyses that some countries have «better» corporate laws than others: these are the common law countries (in particular US and UK), which perform much better (in terms of separation and access to finance) than European continental ones, in particular the Napoleonic civil law countries, such as Italy and France.*

Specifically, they take into account (as indicators of a “good” law): the possibility for shareholders to initiate derivative suits against CEO/board members, the possibility to use proxy votes, the absence of an obligation to deposit shares before shareholders’ meetings, a low percentage of share capital needed to call a shareholder meeting. All these instruments should facilitate minority shareholders in “voicing” their dissatisfaction with the management of the company, thus reducing the risk of expropriation. They also include the impossibility of deviating from the “one share-one vote” rule, a rule that ensures that the market for corporate control is more efficient. As an index of an efficient enforcement of these laws, they use the evaluation of international rating agencies on the different systems.

One main criticism to their approach is that they take into account only some corporate law provisions, focusing on those that might reduce agency costs due to private benefits of control (i.e., expropriation of minority shareholders) and not on features that might minimise managerial agency costs. We’ll come back to these criticisms later.

⁶ See LA PORTA *et AL.* (1997; 1998; 1999; 2000).

An extension of this approach is the one relating to the importance of “norms” rather than just the written law⁷ in explaining the differences in private benefits of control across countries and hence — indirectly — in corporate governance structures: in some countries (e.g., the Scandinavian ones) the adequacy of social norms might make legal rules and their enforcement less relevant.

(ii) A second kind of explanation is due to M. Roe himself. Roe (1994) explains part of the difference, especially between the US and some European continental countries (such as Germany) as a populist political response of the US government to the concentration of power in the hands of investment banks that led to the separation between commercial and investment banks and hence to an even more limited role of the latter in the ownership structure of firms in the US. Other American financial institutions were similarly limited in their corporate governance roles. These limits, in turn, given the large need of finance of US growing firms, generated the large public companies with extremely dispersed shareholders, whereas in Germany banks remained one of the important shareholders of companies.

(iii) Both these theses do not explain why — if the regulation is inefficient — it has not been changed or repealed. Bebchuk and Roe (1999) argue that inefficient regulation can persist as a result of «path dependance»: initial ownership structures may give some parties incentives and powers to impede changes in them and determine which rules will be chosen afterwards.

(iv) Easterbrook and Fishel (1991) and Easterbrook (1997) argue instead that all the corporate structures we observe have an economic purpose. The widely held corporation and the closely held corporation are both efficient, but in different contexts. If they were not, they would not have grown and survived. Easterbrook (1997) argues that the structure and needs of the financial system and the forces of the market create the necessary regulation, not the other way round. On this line of reasoning Mayer (2000) and Carlin and Mayer (1999) suggest that a concentrated ownership might be better for long term investments, which require a long time to produ-

⁷ See COFFEE J. (2001).

ce returns, whereas a dispersed ownership is more efficient for shorter term projects and highly innovative ones. Hence the governance structures that we observe might be the response to industrial and financial structures of the different systems.

4. - Mark Roe's Political Determinants of Corporate Governance

Mark Roe's book is extremely rich. In dealing with the question "what determine corporate governance", first of all it criticises the "law matters" thesis of LLSV as being perhaps relevant but not central as the recent academic literature has made it to be. Secondly, he proposes a further explanation of the differences in corporate governance structures, based on the political conditions of a country. Thirdly, it introduces other institutional characteristics that affect corporate governance, such as the competitive conditions on the product markets (which can be in turn affected by the political conditions).

4.1 Corporate Law's Limits

The first critique of Mark Roe to the LLSV thesis is that implicitly the authors assume that private benefits are the only possible source of agency costs in corporate governance and that they can be corrected by legal instruments (i.e., the ones they include in their empirical analysis). However (as Roe argues in section VI of the book, which develops his previous article "Corporate law's limits") there are other agency costs of corporate governance — arising in particular when ownership is dispersed — i.e., "bad decision making", due to managerial mistakes, shirking, or desire for empire building. And these are harder to correct by the law: in particular company law is not well equipped to reduce them because of the business judgement rule that shield directors and managers from legal action (except if they have conflicts of interests or have acted fraudulently).

Moreover, Roe argues, if a good corporate law is one that constrains private benefits then it is as likely in theory to favour blockholdings as to decrease them, since in these cases also minority investors in concentrated ownership structures would be more willing to invest, because the insiders are more constrained from “stealing” from the investors. Hence the observation of a concentrated ownership is not necessarily a signal of “bad law”.

Finally, Roe criticises the measures used by the authors: first because it is extremely difficult to judge what is a “good” corporate law and what is a “bad” law, i.e., the choice of the relevant provisions is always somehow arbitrary. Secondly, because different rules in different countries or institutional contexts might perform the same function, one should consider the different functions rather than very specific rules. The LLSV choice of the indices is made on the basis of what is included in US corporate law and this might somehow bias the results⁸. A better way to evaluate how good the law is, would be to measure the level of private benefits of control (based on the difference between voting and non voting shares or on the premiums paid on control blocks trades) since they should correlate with laws that constrains them. The data actually show that some of the countries with concentrated ownership (Sweden, Germany) have fairly low private benefits, which should be an indicator that they have a good corporate law. This tends to invalidate the empirical analyses of LLSV.

As a whole Roe’s critiques are largely convincing. Some minor observations could however be made. Concerning the first point (private benefits vs managerial agency costs), one could actually argue that also some company law provisions may be useful in constraining managerial agency costs as well; LLSV consider mainly judicial instruments that reduce private benefits, but some of the ones they include might indirectly work to reduce managerial agency costs and hence allow separation. This is the case for the rules that ensure one share-one vote, which typically favour an efficient market for corporate control. Hence in some respect the

⁸ Under this respect, the indices used to compare the effectiveness of “enforcement”, which are based on subjective judgements of some relevant agents do not suffer from this critique.

law might be effective at reducing also some agency costs of separation.

Concerning the second point (a good corporate law favours both dispersed and concentrated ownership), one might notice that blockholdings have costs for the owners (liquidity and diversification costs; moreover they impose financial constraints to growth): in order for controlling shareholders to be willing to keep them, some forms of private benefits (possibly not damaging minority investors) must be present.

Finally, with reference to the private benefits measures, it has to be noticed that it is extremely difficult to obtain them. First they might include some “non pecuniary” or “non dissipative” ones, i.e. related to some social or psychological value associated to being in control, which is even harder to measure. Secondly, the data on which the measures are based are very scarce (i.e., usually very few observations are available for each country⁹). Hence the argument based on these measures is not completely conclusive.

4.2 The Political Determinants

Having “rejected” the corporate law as the main explanation of ownership concentration (at least in its “LLSV version”), Roe proposes a further possible determinant of corporate governance, a political one. The argument is basically the following.

In order to have corporations that can produce and sell products a country must guarantee sufficient social peace inside the corporation. In the US, social conflicts have been relatively low, possibly due to the high (geographic and economic) mobility and to the limited government involvement¹⁰. In some countries social peace was achieved by becoming social democracies, where the state often sided with employees. In these countries the diffusely-owned public firm did not fit well. For disperse ownership to prevail, managers

⁹ See, for example, DYCK A. - ZINGALES L. (2004).

¹⁰ Economic conflict rather appeared in the opposition to the concentration of economic power, leading to an antitrust legislation and to the fragmentation of financial institutions.

must be somewhat tied to shareholders, but in social democracies this was not possible: social democracies press managers to stabilise employment, to forego some profit-maximising but risky opportunities for the firm and to use up capital in place rather than to downsize when markets are no longer aligned with the firm's production capabilities.

This claim is supported first of all by the observation that the current means that align managers' objectives with diffuse shareholders' ones in the US — incentive compensation, hostile takeovers, strong shareholders-wealth maximisation norms — have been weaker in continental democracies.

Secondly the claim is tested through some correlations (in part III of the book), showing that if nations are arrayed on a left-to-right political scale and then on a concentration to diffuse ownership scale, the two scales correlate. However, the political indices refer mainly to 1980-1991 whereas corporate governance structures seem to be affected by longer term factors. For example, Germany and Japan are ranked among the most right wing nations, in some but not all of the political measures Roe uses, yet they still have a rather concentrated ownership.

The correlation between politics and ownership separation is even higher if one considers the employment protection legislation index, which might actually be a better proxy for the aims of the author¹¹. This evidence is interesting, but in order to be fully convincing we would like to see some regressions, controlling at least for the usual variables, such as per capita GDP.

Finally — and in principle more powerfully and convincingly — Roe tests his theory by analysing some (relevant) historical cases: France, Germany, Italy, Japan, Sweden, UK, and the US. These cases are particularly interesting because some of them might actually be considered outliers in the "law matters" thesis. Germany and Sweden have corporate laws which are not as good as US and UK, but not as bad in protecting minority stockholders as France or Italy, and also have measures of private benefits which are not too distant from the Anglo-Saxon ones. Still they show a

¹¹ It is intermediate with an index of income inequality.

highly concentrated ownership. Roe's political theory might be very helpful here.

In part IV of the book, Roe offers his interpretation of the historical evolution of these countries. In France (which has a very high concentration of ownership and a "bad" law) at the beginning of the 20th century the government was conservative and "anti-labor". This allowed a strong initial development of securities' markets. By mid-century, and particularly after WWII, a left wing government imposed the stabilisation of employment inside the firms as an objective: no downsizing was easily accepted, corporate law provided that «firms should be run in the social interest», incentive compensation mechanisms were initially rare (stock options were attributed to employees only to fight takeovers). In Germany, co-determination in large companies¹² (a corporate expression of social democracies) made the boards weak, in terms of excessive size, limited number of meetings, making it difficult to sell the shares of the companies, because distant shareholders couldn't rely on strong boards. In Italy a strong role of the communist party and a Christian democratic party supporting small firms and basically against the most radical version of capitalism impeded the development of dispersed shareholdings. In Japan, after the war, social peace was ensured through life-time jobs: this required an accommodating governance, which implied having stakeholders such as the main banks, that did not disrupt the system. In Sweden, a reasonably good corporate law, or norms that supported high trust, kept insider expropriation low: this made it possible to maintain a system where controlling agents would pursue objectives more in line with a social democracy than pure managers would do. Finally, the UK at the beginning of the century had good laws and conservative governments, which allowed the development of securities markets. But then family control persisted in many firms until the 1970s. Only with a conservative government the final step to a full separation was made.

As a whole, the historical account of the political theory seems to offer useful insights, especially at the comparative level. However

¹² The compulsory participation of labor representatives in the supervisory boards of large companies.

in some cases the interpretation of the evolution is not fully convincing. For example, in the case of Japan, the concentration of ownership¹³ is associated with the widespread phenomenon of keiretsu, which emerged after the US occupation "imposed" a dispersed ownership. Keiretsu (which are horizontal and vertical groups, with main banks and networks of shareholdings) are a means to ensure control and avoid the discipline of the market for corporate control. It seems therefore that they are an instrument to ensure managers (of both industrial companies and banks) a lifetime job (certainly with political support): hence lifetime employment for workers appears more a consequence of the stability of ownership assets.

In the English case, some recent analyses¹⁴ show that at the beginning of the century investor protection was limited, but dilution of inside ownership was already substantial, basically thanks to informal relations of trust between directors and (dispersed) shareholders; that in the second half of the century trust was "substituted" by formal regulation which allowed a higher level of shares' trading and the emergence of a market for corporate control that facilitated the rise of institutional shareholdings. Actually, at the end of the century there is some evidence of an increase in ownership concentration (due to the growing role of institutional investors). If this analysis is correct¹⁵, in a sense it supports an extended legal theory, i.e., one could say that good rules (or their substitutes, such as trust) are necessary for the diffusion of ownership. The "exit" of families from the companies in the second half of the century (but ownership was already rather dispersed, with the families' representatives maintaining the role of directors or president) might further be explained by the increase of the top rate of inheritance duties in 1949.

Also in the Italian case, which seems to fit well in Roe's thesis, the history is somehow more complex. The phenomenon of ownership concentration (often ensured through pyramidal groups) dates back to the early 20th century and survives through the fascist pe-

¹³ It is not clear whether it has to be considered high or low in the international comparisons.

¹⁴ See FRANKS J. - MAYER C. - ROSSI S. (2003).

¹⁵ It is actually based on a relatively small sample of firms.

riod. In Italy (a limited degree of) separation has been achieved through instruments, such as pyramidal groups, which are not “market friendly”, but are allowed by a not too strict regulation. The concentration of ownership and the use of pyramids has increased until the 1980s and has decreased only after the privatization program (which was actually more actively pursued by left-wing governments) and the introduction of more stringent legislation¹⁶.

Hence, the nation by nation description supports the thesis of the author up to a point, or at least with some outliers. As a whole, the author’s thesis complements (but this is what he actually claims) other theories rather than substitute the other explanations. He claims that politics can’t be left out of the picture, and often, but not always, it’s the most important explanation for ownership separation or its absence.

4.3 The Other Institutional Determinants

Finally, Roe considers other possible sources of differences, and in particular the degree of competitiveness of product markets of the different countries¹⁷. When product markets are not competitive¹⁸, rents are higher and the potential agency costs for shareholders increase. Managers and directors have more slack, hence even the discipline of capital markets is not binding: those who manage the company are not constrained to pay the lowest possible cost of capital (they can use up the rents from the product market and still have profits for owners), therefore they do not have to offer investors the best “corporate governance system”, i.e., a system that offers them sufficiently guarantees for their investment¹⁹. The result is that the only way for owners to control adequately for these agency

¹⁶ See, for example, AGANIN A. - VOLPIN P. (2003).

¹⁷ The author, in the “other” explanations includes also some “political economy” factors, namely the activity of interest groups, the backlash to some previous policy measures, more generally measures that, even if not efficient — or not first best — for the economy, avoided unsustainable social reactions.

¹⁸ Because the country is small and closed, because monopolists manage to have political support...

¹⁹ Moreover, according to Roe, when rents are higher, conflicts within the firm might be more intense over the distribution of the rents themselves.

costs is concentrated ownership. Hence less competitive systems are characterised by more concentrated structures. Actually the author finds a positive correlation between a measure of the intensity of competition²⁰ and ownership dispersion. Again, the intuition is appealing and extremely relevant for its policy implications. Given its importance, it would deserve further empirical evaluation: the simple correlation is in fact driven mainly by the juxtaposition between Anglo-Saxon countries (UK and US), where mark-ups are very low, and basically all the other countries (with the exception of Canada) where markets are much less competitive. However there are various outliers to be explained; one would also like to see a regression analysis (i.e., including other controlling variables). It would be interesting to extend the analysis to other sectors, mainly those which are not open to the international competition.

5. - Conclusion

As we have seen, this book is extremely rich and stimulating. Maybe the most important contribution it makes is to underline that multiple factors have to be considered when trying to explain different governance structures and that among them complementarities exist: legal rules are important but maybe themselves expression of political objectives; other institutions are necessary to complement company law (or in some cases can substitute them, such as trust); the degree of product market competitiveness is an essential component and determinant of corporate governance and ownership.

What are the policy implications of this analysis? The main one seems to be that simply working on reforming some legal provisions might not be sufficient to achieve a different governance structure. Complementary changes might be necessary or, better, the whole institutional setting should be made consistent with the objectives (for example the labor law or bankruptcy procedures should be coherent with company law). In the Italian case this might help to explain

²⁰ Proxied by an average of the OECD estimate of mark ups in "heavy industries".

why the “improvements” in the legal setting for listed firms due to the introduction of the Testo unico della finanza in 1998 did not (yet) induce major changes in the ownership structure of Italian listed firms.

Finally, it is interesting to notice how, even if the author is explicitly not offering an “evaluation” of the different models, as is the case instead in the “law matters” literature, it is somehow implicit in the analysis that systems that do not favour a high degree of separation (i.e., where ownership is too concentrated) pose a substantial obstacle to some firms’ growth. This somehow corresponds to the view that has become common in the second half of the 1990s, that Anglo-Saxon systems are better equipped to support firms’ growth, especially in periods when radical changes are necessary²¹. This can be contrasted with the view of the same author in his 1994 book, that the US regulation in the 1930s posed an obstacle to the involvement of financial institutions in corporate governance, limiting the possibilities for its evolution. Actually, in the early 1990s the German/Japanese governance systems were perceived as superior because they enabled a long run management of the companies.

Maybe we could more humbly derive a — more neutral — testable implication of these analyses, i.e., and that corporate governance structure is one the factors explaining the differences in average size (and growth) of firms. If this proved correct, we would have identified one of the reasons for the very small size of Italian firms.

²¹ Although the author denies this difference, arguing that the US tended to suppress agency-cost-reducing concentrated ownership structures while other systems tended to suppress separation.

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