Corporate governance and capital flows

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Abstract

Purpose – *This paper aims to analyze existing corporate governance rules which aim to regulate and control the following type of problems: to restore confidence in the financial markets, to reformulate the existing corporate governance systems and mechanisms that have been inadequate, and, finally, to rethink the relationship between ethics and economy. It also aims to identify the factors determining the corporate governance systems and mechanisms in a global economy.*

Design/methodology/approach – *The paper reports the results of a comparative analysis between different corporate governance systems and mechanisms. In addition, in order to explore the role of institutional determinants in attracting foreign direct investment (FDI) flows, this study considers variables such as an index of shareholder protection, openness to FDI and the interaction between the two above mentioned variables.*

Findings – *This analysis confirms the economic theory that less open countries are characterized by stronger ownership restrictions and a weak corporate governance mechanism. Conversely, open market and investment regimes are particularly powerful instruments to attract investment in general and FDI in particular.*

Originality/value – *This study provides a survey of the main system and mechanisms of corporate governance all supported by a survey of recent developments regarding the empirical analysis on the role of institutional determinants in attracting FDI flows.*

Keywords *International investments, Corporate governance, Capital*

Paper type *Research paper*

Introduction

The term corporate governance is a relatively new one both in the public and academic debates. Although the issues it addresses have been around for much longer, at least since Berle and Means (1932) and the even earlier Smith (1776), in recent year questions related to the effectiveness of corporate governance and corporate accountability have been subjects of heated debate after the corporate accounting scandals around the world (Enron, Vivendi, Cirio, Parmalat, Ansett, Pan Pharmaceuticals). These examples of corporate failures and managerial misconduct put in evidence the need to give more attention to corporate governance practices. In the light of this debate, economists, business people and international policymakers have increasingly come to recognize that strong interrelationships exists between macro and micro foundations. For example, Acemoglu and Johnson (2003) criticize the prevailing view that considers economic crises as the result of mismanaged macroeconomic policies. On the contrary, these authors claim that:

> Distortionary macroeconomic policies are chosen because politicians believe that high inflation or overvalued exchange rates are good for economic performance. Instead, distortionary policies may reflect underlying institutional problems in these countries – weak protection of investors' property rights, weak rule of law, and weak constraints placed on politicians and business elites (Acemoglu and Johnson, 2003, p. 327).

Received December 2010
Revised February 2011
Accepted February 2011

There is no universally accepted definition of corporate governance, rather there exist different definitions that analyze specific aspects of corporate governance. The majority of the definitions articulated in national and international codes relate corporate governance to control and to supervision of the company or of management or of managerial conduct. This is a consequence of a dominant view of corporate governance which deals with the relationship between manager and shareholders and in particular the structure and functioning of the boards of directors. Tricker (1984, p. 7) distinguishes corporate governance from management concluding that management is about running the company and corporate governance is about ensuring that the company is run properly. Keasey and Wright (1993) in analyzing corporate governance distinguish the decision making, the structures and processes associated with the production, control, accountability which in turn involve the monitoring, evaluation and control of organizational agents to ensure that they act in the interests of shareholders and stakeholders.

In the current process of globalization, foreign direct investment flows (FDIs) play a starring role.

It is important to underline that recent attitudes toward FDI have changed considerably, as most countries have liberalized their policies to attract investment from multinational enterprises. Indeed, FDI has actively been promoted by the Washington consensus as a panacea for economic development. In particular, structural adjustment programs such as privatization, trade liberalization, reduction in state ownership, more and better transparency in economic systems, internationalization of capital markets and macroeconomic stabilization policies have led to increasing market integration at a global level[1], making FDI more interesting for both advanced and less advanced industrial countries. Considerable efforts have been made by the advanced industrial countries to persuade developing countries and emerging economies of the benefits of removing the barriers on FDI based on the argument that direct investment flow can play a significant role in promoting economic growth (raising capital, labor and total factor productivity), creating new local employment, introducing new know-how and forcing local firms to improve their managerial systems. As a result, an increasing number of host governments have provided attractive opportunities for multinational in term of cost advantages, economies of scales and multi-plant economies. Given the extensive financial resources and technical know-how of MNCs and other positive effects on the host economies, many countries compete to have these firms locate to them by offering a favorable business environment, opening up their economies to foreign investment setting low corporate tax rate, fiscal incentives, financial incentives, infrastructures and monopoly rights. Strong arguments can be made that international investment incentives in a host country should attract more foreign investors. This view is focused on the importance of international investment incentives and subsidies that host governments often introduced to encourage multinational enterprises to invest in their markets.

According to the UNCTAD (1996), as a consequence of the globalization of the world economy, investment incentives have become more significant determinants of foreign investments and few countries compete for foreign investment without any forms of subsidy. It is a matter of debate, however, whether incentives or subsidies are really justified. The school of the ''race to the bottom'' theory asserts that MNEs induce countries to compete against each other to attract FDI, thereby worsening their living standards. For example, countries can compete by relaxing labor standards, which could have adverse effects on the welfare of the host country's population. Furthermore, the benefits of MNCs activities in less developed and emerging economies are not always reflected in domestic firms' value added growth. When domestic firms lack the capacity to absorb and internalize spillovers, FDI is not the most effective tool to promote technological and industrial development. In such cases the advantages of FDI go solely to the multinationals who can pursue their interests: profit's maximization, protection of its patents, blueprints and technology[2].

Advocates of the ''climb to the top'' approach consider that MNCs provide the best option for achieving efficient international financial markets and allocation of international capital flows. The theory suggests that the beneficial effects of FDI flows are more likely to be detected when the receiving country has a certain amount of absorptive capacity in term of human capital, quality of governance and macroeconomic policies. For example, Borensztein *et al.* (1998), find that FDI has a positive effect on growth when the level of human capital in the host country is sufficiently high (threshold effects). Thus, in order to benefit from the advanced technology introduced by foreign firms, the host country need to build up a certain amount of absorptive capacity in orders to take advantage of financial globalization. However, FDI may also lead to negative spillovers, as domestic firms may be displaced by the foreign firms, or find that the cost of factors of production increases as a result of the foreign direct investment. Authors (Chang, 1999; Stiglitz, 1994) support the view that benefits of FDI for the host countries may depend on the manner in which FDIs are attracted to a country. For example, in a context in which countries compete aggressively by offering subsidies to potential investors, it is possible that any potential net benefits generated by FDIs will be competed away, and will accrue to the foreign investors.

Some authors (Krugman and Obstfeld, 1999) considers FDI inflow to a country as a positive signal, suggesting that this is a result of a correction of a domestic distortion (crony capitalism). In contrast, other authors (Fernández-Arias and Hausmann, 2000) consider high level of FDI inflow as a signal of a weakness of the host country (poor property rights, inefficient markets and weak legal and financial institutions), rather than its strength. Then, the share of FDI inflows in total capital flows is larger the when the legal and economic risks of doing business in a particular country are higher. In the light of this debate, governments, academic studies and international agreements have increasingly come to recognize a strong relationship between quality of institutions and investments flows. Empirical studies claim that cross-country differences in growth and productivity may be related to differences in institutions, political stability, level of education and legal environment.

Most of these studies (Wheller and Mody, 1992) conclude that the firm must design a strategy that will attract international investors. As alternative way to attract FDI, countries could compete by improving their governance, the quality of their labor forces or the quality of their infrastructures. For example, efficient legal systems, low levels of corruption, high degree of transparency and good corporate governance may have a quantitatively important impact on a country's ability to attract foreign direct investment (Wei Shang, 1997; La Porta *et al.*, 1998; Hausmann *et al.*, 2000; Alesina and Dollar, 2000, Shatz, 2000).

Review of the relevant literature

This section briefly reviews the large academic literature on FDI in a host country. Foreign direct investment is one investment option firms choose when expanding into international markets.

By definition, a firm becomes multinational when, through direct investment, it establishes business enterprises abroad in which it exercises some level of ownership and control. Up until the second half of the twentieth century, most of the mainstream theories regarding FDI explained only partial aspects of the internationalization process of production. Some theories focused on the countries' characteristics (factor endowments) and others concentrated only on the role of firms (neoclassical approach). In the second part of the last century there was a valid attempt given by Dunning (1988, 1998), the new trade theory (Markusen *et al.*, 1995; Markusen and Venables, 1999; Markusen and Maskus, 2001) and other approaches to consider both the theory of firms and the international trade theory that explains the determinant of FDI and the role of multinational enterprises (MNEs). In general, in deciding whether to invest abroad, a multinational must develop a competitive advantage (i.e. economies of scale and scope, superior technology, managerial expertise etc.) powerful enough to compensate the firm for the potential disadvantages of operating abroad (higher agency costs, political risks, cultural and linguistic differences, unknown market, foreign exchange risks, etc.). It is generally recognized that the H-O framework appears to give a sound theoretical analysis for the early form of FDI where the flows of investment were from industrialized countries toward less developed countries. In fact, in this case, a country's characteristics in terms of factor endowments seem to drive the FDI pattern. Capital moves from capital-abundant countries scarce in natural resources towards capital-scarce countries abundant in natural resources (resources-based FDI). The H-O framework also seems to explain a more recent form of integrated type of FDI where MNEs move towards countries characterized by abundant and cheap labor. Much of the new classical and new trade theory (NTT) have expended efforts on providing support for the increased importance of trade between industrialized countries and the prevalence of intra-industry specialization (horizontal and vertical patterns) between them, rather than the growing importance of multinationals relative to trade (Markusen and Venables, 1999). According to Markusen (1995):

> Multinational enterprises are firms that engage in foreign direct investment, defined as investments in which the firm acquires a substantial controlling interest in a foreign firm or sets up a subsidiary in a foreign country.

Usually, multinational enterprise is based in one country (the home or source country) and establishes new activities in other countries (the host or receiving country). As a consequence, production is geographically divided between different countries. As described by Markusen (1995), there are two ways a firm can divide its productions and become multinational. The first way is to duplicate some of its activities, building a plant in a foreign country (the ''host'' economy) in addition to the one installed in the country where the multinational firm is based (the ''home'' economy). The idea is that if final consumers are dispersed across different countries, a firm faces a trade-off between the loss of economies of scale associated with multiplants and the reduction of transport costs it can achieve by producing locally a similar product for each market. Thus, firms exhibiting multiplant economies of scale in production become multinational to avoid costs associated with cross-border trade, dispersing the production and supplying the market directly through an affiliate. Thus, FDI can act as substitute for trade under horizontal multinational activities patterns in which countries are similar in size and factor endowments, firms economize on trade costs due to transportation, trade barriers and tariffs. Authors such as Markusen and Maskus (2001) and Markusen and Venables (1999), claim that most direct investment flows from rich countries to other rich, capital abundant countries. Therefore, multinational enterprises locate production plants in similar, high-wage countries, which is consistent with the view that FDI is driven more by market access than by wage differences[3]. In addition, according to the ''convergence hypothesis'' (Markusen and Venables, 1999) multinational companies will tend to displace national firms and trade as total market size increases and as countries converge in relative size, factor endowments, and production costs.

Markusen and Maskus (2001)[4] tries to explain why larger and higher income developing countries, such as Brazil and China, receive large amounts of FDI. The motivation for this approach comes from the fact that affiliates in developing countries export a large share of production back to the multinational's parent country. This is in part related to direct cost and factor requirements. Multinational enterprises need local skilled labor as well as reasonable infrastructure to build a final product, and these requirements are only found in high-income developing countries. A country's size matters because not all of the final production needs to be shipped back to the parent country and is instead consumed by the local market. Turning to the empirical analysis of the models derived by Markusen, many hypotheses regarding multinational enterprise activities are tested and most of the results fit well with the theory.

The appropriate ownership structure when a multinational enterprise decides to invest in a foreign market and then to establish an affiliate, has been a central issue in economic theory. Although the globalization process has suggested that international alliances are essential to the success and survival of multinational enterprise in a foreign market, recent researches have been focused on the internalization approach which offers only a partial explanations of the ownership preferences of multinational for other than wholly-owned affiliates. Then, the major limitation of this approach in its current form is that it focuses on one mode of entry: the establishment of a wholly-owned affiliate. Then, globalization have diminished rather than accelerated the share-ownership mode of entry and have created more opportunities for wholly owned foreign affiliates. In general firm would have a strong economic incentive to avoid joint-venture arrangements since these are regarded as being inferior to wholly-owned affiliates in allowing the firm to maximize the returns available on its firm-specific advantage. Thus, internalization theory focuses primarily on the situation where total ownership or direct mode of entry are the only alternatives available to deal with market imperfections.

The World Bank (2001) reports that in developed countries FDI through merger and acquisitions predominated over green-field in the late 1990s; the reverse it is true in developing countries where joint ventures have emerged as an important form of international alliances.

Institutional determinants of FDI: corporate governance

One factor receiving increased attention in international business is a country's corporate governance system and practices. Literature on corporate governance does not give one specific definition of corporate governance. There exist different definitions that analyze specific aspects of corporate governance mechanisms. The majority of the definitions articulated in national and international codes relate corporate governance to control of the company, of corporate management, or of company or managerial conduct.

The traditional definition of corporate governance given in the Cadbury Report and Recommendations (Cadbury, 2000) states that:

> Corporate governance is the system by which businesses are directed and controlled.

In this traditional definition, corporate governance[5] is also considered as a cornerstone of ethical conduct within accounting practices such as the integrity and objectivity of accountants and auditors. These, have been central issues in the Enron scandal where ''Enron' accountants acted as both external and internal auditors and also as consultants'' (*The Economist*, 2002), thus calling into question their integrity and the reliability and transparency of the information they provided to the shareholder and to regulators/government.

Recently, several researchers, have started to analyze corporate governance issues from a comparative perspective. By this approach, authors (La Porta *et al.*, 1997; 1998; Shleifer and Vishny, 1997), have empirically measured the impact of corporate governance on economic growth and have elaborated a more precise definition of corporate governance:

> Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishny, 1997, p. 737).

Hence, starting by a comparative empirical perspective, much of the research raises a range of important issues concerning the difference between corporate governance systems, the interaction between law and finance, the role of financial markets in promoting growth and the role of governance-related institutions in enhancing economic development. Corporate governance practices differ among firms and organizational forms and include the determination of ownership structure, accounting rules, protection of minority shareholders, board of directors powers and so on. In particular, it aims at regulating the separation between ownership and control and at balancing limits on managerial discretion and minority shareholders' protection. Imposing regulations – specifically efficient corporate governance systems and rules – is considered necessary to overcome the conflicts between manager (or controlling shareholders) and (non-controlling) shareholders, thus insuring that the latter's interests are protected.

The archetypal corporate governance problem arises from a conflict of interest between manager and shareholders, based on imperfect information. This creates a principal-agent problem, generally compounded by the collective action problems inherent to widely dispersed ownership by non-controlling shareholders. For example, when corporate ownership is widely dispersed and ownership and control of management are separated, dispersed shareholders may lack capacity, incentives and power to monitor the corporate managers. In theory, one solution is represented by a supervisory body monitoring management. For this reason, where equity markets are highly liquid and shareholders are widely dispersed, corporate governance codes tend to focus on supervisory body structures and practices. This insures that the supervisory body is a distinct entity, capable of acting separately from management, as well as to encouraging shareholder participation in voting[6].

Starting by the consideration that after the global liberalization of capital flows, corporate governance has emerged as a crucial element in increasing the returns on investments, reducing the degree of risk and promoting financial development, researchers focused on the strategic importance of a good and efficient corporate governance mechanisms in attracting the foreign investor. La Porta *et al.* (1997, 1998)[7] consider the interaction between law and finance (Berglof and Thadden, 1999) and in particular they consider the international differences in investor legal protection as a key determinant for financial development. They classify country legal origins as: Anglo-Saxon (common law), French, German and Scandinavian (civil law), and attribute the differences between the Anglo-Saxon and Continental European system to the countries' legal systems and to the role of the State. This is because, the degree of investor protection determined by the country's legal origin is negatively related to what the degree of involvement of the state in the economy was when business law was first introduced.

Rajan and Zingales (1998) raise a similar point, even though they question the importance of the legal protection and focus on the development of the capital markets directly. Additionally, LLSV establish eight indicators for shareholder protection and six for creditor protection. LLSV argue that financial markets interaction with the legal framework may affect corporate performance. Additionally, they establish a strong correlation between legal origin, investor protection and ownership concentration. When they control for investor protection, the significance of legal origin disappears, indicating that legal origin affects finance through investor protection. However, LLSV indicators and country legal origin classification have been strongly criticised. For example, the classification of countries by legal origins in common and civil law has been considered ''particularly superficial''[8] because, for example, some differences exist between countries included in the same groups.

Another criticism concerns the biased or misleading measures of the quality of corporate law and the low level of variability of the results. However, despite these criticisms, LLSV's political approach to corporate governance has represented an important benchmark to comparative studies[9]. Pagano and Volpin (2001) using the approach of the new political economy, analyze the role of institutions and in particular how the political decisions to set legal rules are based not only on ideology, but on economic interests as well. They find that this approach allows a better understanding of the existing international differences in financial regulation.

Pagano and Volpin (2004)[10] analyze the political determinants of the degree of investor and employment protection starting by the assumption that under proportional voting, the political outcome is a low degree of shareholder protection and a high degree of employment protection. Thus, a system characterized by stronger worker protection (i.e. Germany) presents a weak shareholder protection level. Conversely, a system characterized by stronger shareholder protection will present a weaker worker protection (i.e. USA, UK).

Using a panel of 21 OECD countries, the LLSV shareholder protection index and other political variables, these authors find that the proportionality of the voting system is positively correlated with employment protection. In a panel of 45 countries, they find that the proportionality of the voting system is significantly and negatively correlated with shareholder protection (update data of LLSV).

Rossi and Volpin (2002), using a large sample of deals announced in the 1990s and completed by the end of 2001 in 49 countries, study the determinants of merger and acquisitions around the world, focusing their attention on differences in law and enforcement systems across countries. They find that the volume of merger and acquisitions and the premium paid are significantly greater in countries with better investor protection.

Bris and Cabolis (2002), analyze the effect of change in corporate governance induced by cross-border merger on industry value, instead of focusing on cross-country comparisons. They constructed a panel of 9,200 industry-country-year observations[11] and also used LLSV indicators of investor protection. They found that the Tobin's Q of an industry increases when firms within the industry are acquired by foreign firms with better and more efficient corporate governance. In particular they found that legal origin represented a key variable in determining the amount of value created in the case of merger and acquisitions. For example, the acquisition of firms in countries with low investor protection (civil law) by firms characterized by higher investor protection (common law) has a positive impact on the target industry in term of Tobin's Q.

Conversely, target industries do not benefit from acquisition by firms from countries characterized low investor protection (civil law). In sum, all these studies suggest that investor protection strongly influences a country's economic performance, a firm's performance and probably growth. The relationship between corporate governance and economic performance has been the object of one of the most controversial debates after the Asian financial crisis.

As a World Bank (2001) report points out, poor corporate governance, lack of transparency and financial sector weakness could be considered one of the main causes of most financial crises. In addition, according to the World Bank (2001), the Asian crisis was due, among other factors, to a weak banking and financial sector as well as poor corporate governance mechanisms, a lack of transparency, widespread corruption, a weak legal and judicial system and inadequate corporate accounting systems. In this context, corporate governance emerges as a crucial element to increase the returns on investment and reduce their degree of risk. Hence, it is generally assumed that a poor system and practice of corporate governance can hinder efficiency and performance enhancements on the part of firms (CIPE, 2002).

In sum, there is a widespread recognition that a weak international financial system potentially contributes to the propensity for global financial instability. The recent attention to corporate governance issues is not exclusively concerned with advanced economies, but also with less developed, transition and emerging market economies. As far as less developed countries are concerned, corporate governance is supposed to boost the development process in two crucial ways: by raising the degree of transparency of internal financial markets and by increasing the country's political credibility abroad.

Case studies (OECD, 1999a, b) suggest that an adequate system of corporate governance does help to increase the flow of financial capital to firms in less developed countries. In fact, evidence exists that supports the hypothesis that financial markets develop the best in the presence of legal codes that provide protection to shareholders' rights (in particular minority shareholders rights) (Prasad *et al.*, 2003), definition of ownership (insiders owners versus outsiders owners), and regulation of banking sector. However, improving or establishing an adequate system of corporate governance cannot be considered in isolation. As the experience of transition or emerging market economies has clearly shown a reform of the financial system does not help the development process without a more general reform of market institutions.

Among the factors to consider and worth mentioning are: the origin of the legal system, the socio-political and economic systems and the country's stage of development. All these factors make the problems raised by the establishment and enforcement of efficient mechanisms of corporate governance in emerging market economies very different from those experienced in advanced economies[12].

As a consequence of that, promoting clear legal rules has emerged as a crucial new priority in the global liberalization process in order to give more guarantees to foreign investors and to encourage foreign and domestic investments. The reason is that each country must establish a fair and transparent legal and judicial system in order to attract foreign direct investment. After the financial crises of the second half of the 1990s, these requirements have become the major policy priority in many countries. In countries such as Brazil[13] and

Korea the adoption of corporate governance codes has become an unavoidable requirement for the creation of an efficient and internationally competitive market-based corporate sector, which could serve as the engine of a well-regulated financial market and sustained economic growth.

The growing interest in corporate governance codes and rules among countries may reflects an understanding that equity investors (foreign or domestic), are considering the quality of corporate governance along with financial performance and other factors when deciding whether to invest in a company. For example, a McKinsey survey of investor perception (2000-2006) indicates that investors are willing to pay more for a company that is well governed, all other things being equal.

Finally, authors raise a range of important issues analyzing the effect of the interaction between law and finance, the quality of the legal system, the role of institutions in economic development, the ownership structure, the rules and codes that protect investors.

For example, Stein and Daude (2001), find that the quality of institutions has a positive effect on foreign direct investment flows. Using a panel of 63 host countries and 28 OECD source countries, they analyze the impact of institutional variables on bilateral foreign direct investment flows for 1996. The result suggests that countries that want to attract foreign investors should improve the quality of their institutions. These authors use, among other explanatory variables, the index of shareholder rights developed by LLSV. The positive and significant coefficient indicates that shareholder protection matters for the location of foreign direct investment. Wei Shang (1997) finds that corruption, as well as uncertainty regarding corruption, has significant and negative effects on FDI location.

Hausmann *et al.* (2000), study the effects of institutional variables compiled by Kaufmann *et al.* (1999), as well as indices of creditor and shareholder rights from La Porta *et al.* (1998). They find that better institutions lead to a reduction of share of FDI inflows. They conclude that, in comparison to FDI, other forms of capital flows are more sensitive to the quality of institutions. Alesina and Dollar (2000) consider the traditional explanatory variables (market size: GDP, Population) and in addition they test for the impact on FDI of trade openness, the level of democracy and a set of dummy variables including common religion and political alliances with the source country, the rule of law and the number of years as a colony of the host country). They use a panel of countries (1970-1994) and found that FDI responds to economic incentives, such as the trade regime and the system of property rights in the host country, more than to political incentives (e.g. colonial past and political links).

Shatz (2000), reviews the changes in investment policy of 57 countries receiving US investments and creates a new rating system for administrative investment openness. The author finds that countries that reformed their investment policies attract more foreign investment flows. In this respect, this research appears as complement to the existing literature. In particular, in order to explore the role of institutional determinants in attracting FDI flows, this study considers variables drawn from different sources. The first is an index of shareholder protection developed by Pagano and Volpin (2004) on an expansion of La Porta *et al.* (1998), used as a measure of corporate governance. This variable is an index that varies between 1 and 5, with higher values indicating stronger protection of shareholders.

The measure of openness refers to a country's openness to FDI, as measured by Shatz (2000), and it takes values from 1 to 5, with 1 indicating that foreign direct investment is just allowed and 5 indicating that nearly all sectors are open. Additionally, in order to investigate the relationship between FDI flows and the level of openness and shareholder protection, we consider the interaction between the two above-mentioned variables. By considering openness to foreign investment and ownership restrictions, this study verifies whether ownership restrictions imposed by the host country have any effect on the decision of multinational enterprises to invest abroad and in particular which mode of entry they prefer in establishing new affiliates.

Gravity model: corporate governance and FDI

According to the gravity model for international trade, the amount of trade between two countries is explained by their economic size (GDP), population (openness), geographical distance (physical distance and border effects) and a set of variables that capture common institutional characteristics such as languages, culture, trade agreements, and law system. More specifically, the amount of trade between two countries is assumed to increase in their sizes, as measured by their national incomes, and decrease in the cost of transport, as measured by the distance between their capitals or economic centers. Tinbergen (1962) was the first to apply this formula to analyze international trade flows.

Later, Linnemann (1996) included population[14] as an additional measure of country size, defining the augmented gravity model. This model is generally estimated in a log linear form that provides elasticity of bilateral trade to income (GDP: Y_i, Y_j), country size (population: POP_i, POP_j) and distance (D_{ij}). Usually other variables are introduced to expand the basic gravity model. For instance, variables are added to control, for linguistic, cultural and historical similarities, regional integration, common financial development and structure, and common currency.

In analogy with the evolution of trade, the gravity model has been used to model the international pattern of foreign direct investment (see Stein and Daude, 2001; Portes and Rey, 1999). Empirically, several modifications have contributed to the improvement of the gravity equation (see, for example, Mátyás (1997, 1998), Cheng and Wall (2002), and Egger (1999)), and other authors (Bergstrand, 1985; Helpman, 1987; Wei Shang, 1997) have contributed to the refinement of the definition of variables already considered in the analysis and adding new variables previously not considered. Actually, according to Frankel *et al*. (1998):

> The gravity equation has gone from an embarrassment of poverty of theoretical foundations to and embarrassment of riches.

The issue of the correct specification for a gravity model of FDI is still a matter of open debate. In this respect, this present work appears as complement to the existing literature and considers four possible specifications.

The empirical strategy used in Talamo (2009) is based on the gravity model that is considered as the standard model in the empirical literature on the determinants of bilateral trade. Following this approach for international trade, FDI flows are expected to be greater between countries with greater development and openness markets, proxied by GDP per capita, Population and GDP in real US$, with linguistic similarity, with regional trade agreements between countries, with higher shareholder protection and with greater openness to foreign investors. On the other hand, bilateral FDI flows are expected to be negatively correlated with higher geographical distance, and higher corporate tax rates. The results obtained for openness to FDI flows are consistent with economic theory and with our expectations.

The positive and significant estimated coefficients indicate that FDI flows are more likely to be established in countries whose governments do not restrict foreign ownership of local business. Thus, this variable has a large effect on the level of multinational activity, as shown in all four regressions. A one-step increase in the openness indicator is associated with a 42, 43, 36, and 34 percent increase in FDI flows. Additionally, in Talamo (2009) we also attempt to measure the effect of efficient corporate governance's mechanism to FDI flows using as explanatory variable a ''shareholder protection'' measure as measured by Pagano and Volpin (2004). The shareholder protection coefficient is always positive and significant. A 1 percent increase in the shareholder protection measure is associated with about 16, 20, and 13 percent higher levels of FDI flows. This result suggests that FDI flows are attracted from countries which offer higher shareholder protection and thus a more efficient corporate governance's mechanism.

In conclusion, taken together, the results show that the estimated coefficients on openness to FDI, corporate tax and shareholder protection are often significant and have the expected signs indicating that FDI are more likely to be attracted in countries whose governments do not restrict foreign ownership of local business, in countries where governments offer corporate tax policies, and in countries offering higher level of shareholder protection. Then, this empirical test shows that countries' attractiveness to foreign investors is quite closely linked to the degree of openness and shareholder protection of their policy. Additionally, in Talamo (2009) we also investigates that, not only the relationship between openness, shareholder protection and FDI flows is positive, but this relationship is quite strong in countries that offer higher level of openness. This second relationship is measured by introducing a set of new dummies. These five dummies capture the link between changes in openness patterns and shareholder protection measures. The positive and significant coefficients on the interaction of shareholder protection and different level of openness to FDI flows indicate that foreign investors are more attracted by countries that impose less ownership restrictions associated to a more efficient corporate governance's mechanism. Thus, a high degree of openness and better investor protection should facilitate the access of foreign investors. The negative and significant coefficients of the interacted variables indicate that for lower level of openness, shareholder protection is also low.

Thus, this result confirms the economic theory that less open countries are characterized by stronger ownership' restrictions and a weak corporate governance mechanism. Conversely, the coefficient of the interacted variable becomes positive once countries present higher level of openness and less ownership restrictions. Additionally, these results suggest that foreign firms are more likely to establish joint ventures with domestic investors when these impose ownership restrictions, higher barrier to entry and at the same time can provide information about and access to local distribution channels. This mode of entry characterizes, for example, less developed countries that present all of the above-mentioned characteristics. On the contrary, less restrictions and protection of investors facilitates FDI flows and positively influences business attitudes. In other work, Fazio and Talamo (2008), investigate empirically the role of corporate and institutional governance in attracting FDI compared to forms of incentives, such as lower taxes and wage costs. The final result shows that corporate governance and institutional quality are important attractors of FDI.

Conclusions

The main analysis of the present work finds that the impact of shareholder protection and openness to FDI variables are always positive, statistically significant and economically very important. Thus, this result confirms the economic theory that fewer ownership restrictions, greater openness to foreign investors and efficient investor protection facilitate the access to foreign direct investment flows.

Finally, corporate governance has been used to describe a much broader relationship between institutions and stakeholders. In particular, corporate governance is increasingly concerned with the role of stakeholders and its impact on the collective welfare of. This is a long-term approach to defining corporate governance and take account of the interests of both shareholders and stakeholders. Therefore, the content of corporate governance has to be extended to include also responsible corporate governance that is about balancing the legitimate interests of all stakeholders involved, with ethics and sustainable growth being of fundamental importance.

Definitions of corporate governance, below, include examples of definitions dealing with the broader view.

> Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society (Cadbury, 2000).

Cadbury definition suggests that corporate governance represents a more general definition with implications also for a firm approach to corporate social responsibility (CSR) and business ethics. As a reaction to recent financial scandals, the business community in the twenty-first century has started to require more ethical behavior from companies. At the firm and institutional level there has started process of re-defining the traditional meaning of corporate governance, specifically the distribution of rights and responsibilities among board, managers, shareholders and stakeholders and at the same time including the new concept of social responsibilities as:

> Companies are part of the wider community and must meet wider social responsibility[15].

Notes

1. These policies are associated with the so-called new economic model (NEM).
2. The important issue of the effects on host countries of competitions with subsidies has been analyzed by Fernández-Arias and Hausmann (2000).
3. Yeaple (2001), using US firms as examples, shows that firms serve foreign markets more through FDI than through export. Then, it concludes that multinationals arise when scale economies in headquarter activities are stronger relative to scale economies in production.
4. Markusen and Venables (1999), Markusen and Maskus (2001) has also developed a model to explain trade and its relationship to affiliate production: the ''knowledge-capital'' model, which is created around the key idea that firms have high knowledge-based assets and fixed-costs, creating firm-level economies of scale. The reduction of trade costs tends to reduce affiliate production when it is of horizontal type, but increase it when it is of vertical type. One result of the model is that vertical production arises when one country is small and skilled labor is abundant relative to the other country, creating and incentive for firms with several stages and different factor intensities to separate production. On the other hand horizontal production arises when two countries are similar in size, creating and incentive to attend both markets with different plants. The type of production – horizontal or vertical – will determinate the effect of multinational activities on trade. FDI is a substitute for trade when a horizontal affiliate is built in a host country to directly supply this market. The idea is that products previously been imported from the home nation are now produced in the host economy, replacing imports. However, if the host nation's affiliate is vertically linked to the multinational's home operations, its production is going to complement trade because there will be an increased exchange of intermediate and final goods between the home and host economies. It is important to notice that, because the pattern of production is determined by the difference between the two countries, trade and affiliate production will tend to be substitutes for similar countries and complements for dissimilar countries.
5. The Cadbury report was issued after a series of financial scandals and related failures of listed companies in the UK. Cadbury Report (p. 11), ''the country's economy depends on the drive and efficiency of its company. Thus the effectiveness with which their boards discharge their responsibilities determines Britain's competitive position . . . ''
6. This view is in contrast with the standard neo-classical assumption that managers act in the best interest of shareholders, namely by maximizing the firm's value, without any conflict of interest.
7. For simplicity we will refer to these authors as LLSV.
8. These authors analyze corporate governance in 49 countries, and they establish a distinction between countries characterized by civil and common law. Once it is established that legal differences exist across countries, these authors consider: shareholders rights and voting procedures; creditors rights, ownership structure and legal enforcement rules. Their conclusion is that ownership concentration characterized small economies, poor investor protection and an inefficient accounting system. In contrast, larger economies are characterized by dispersed ownership, higher investor's protection and a proper accounting system.
9. Recently, Pagano and Volpin (2004) have updated shareholder protection variable which is the LLSV anti-director rights index.
10. M. Pagano and P. Volpin suggest a political economy approach to the investor's protection. Their analysis considers the link between political decisions and economic interests. Moreover, they figured out the distinction between corporatist and non-corporatist countries.

11. Bris and Cabolis (2002) analyze 39 industries in 49 countries in the period 1985-2000 and they construct measures of corporate governance quality of industry by considering cross-border mergers by and of firms in that industry.

12. However, we argue that an adequate mechanism of corporate governance might be more important in some developmental stages of a country, or of a firm's life cycle, than in others.

13. In 2001, BOVESPA, the São Paulo Stock Exchange, launched a new market segment, the Novo Mercado, which aspires to international standards of corporate governance. The Brazilian approach is innovative. Traditionally, new segments have been introduced by stock exchanges to encourage small and medium size enterprises to become listed. Listing rules for the new segments have usually been watered down versions of listing rules on the main board. Not so in Brazil. The companies listed on the Novo Mercado will be prohibited from issuing non-voting shares whilst companies on the main board can do so. They will have to abide by US or international accounting standards and their free float9 will be at least 25 percent. An arbitration panel has been created to settle shareholder disputes. As a result, some investment banks, such as Merrill Lynch, have put the Novo Mercado at the top of their rankings for minority shareholders rights and significantly above the main Brazilian board ranking. The rationale for the creation of the Novo Mercado is to allow companies that want to abide by international best practice to differentiate themselves from the Brazilian main board. It is also expected that their adherence to the Novo Mercado listing rules will allow companies to attract quality domestic and international investors and ultimately lower their cost of capital. For example, Brazilian pension funds will be allowed to invest a higher proportion of their assets in companies listed on the Novo Mercado. Likewise, the Banco National de Desenvolvimento Econômico e Social (BNDES), the state-owned development bank, is offering more attractive lending terms to companies that list there. Source: Fremond and Capaul (2002).

14. Population is normally used in the good trade literature to represent ''openness''.

15. ''Comparative studies of corporate governance codes relevant to the EU and its member states'' Final Report and Annexes, January 2002, p. 44.

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