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Corporate Governance, Entrepreneurship and Economic Development

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Corporate Governance, Entrepreneurship and Economic Development

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Abstract

This chapter address the question of how corporate governance institutions interact with and influence entrepreneurship and how this ultimately affects economic development. Such institutions set the framework conditions within which corporations and their owners act. However, the framework conditions also have significant implications for how capital is (re)allocated. This will in turn influence the conditions for new firms. If resources are locked up in incumbent firms and the financial system fails to enhance reallocation of resources, this may hamper entrepreneurial activities and thus contribute to slower economic development. This chapter reviews the corporate governance – entrepreneurship literature. An extensive survey of all the scientific contributions within corporate governance and entrepreneurship is, however, beyond the scope of this chapter. Instead, we use a cross-country data set to examine the links

between key corporate governance variables and 1) entry of new firms, and 2) (re)allocation of capital in incumbent businesses. We find that countries with highly concentrated corporate ownership and poor protection of property rights tend to have lower entry rates and less efficient resource allocation by incumbent firms.

Introduction

Large corporations have come to dominate economic activities globally (see e.g., Mueller, 2003). At the same time, how these corporations are governed varies greatly around the world. Some countries have highly diversified economic activity with a multitude of both small and large firms, where as other economies are dominated by a few corporations, often controlled by one large or a few large owners or ownership groups. Often these owners also resort to some sort of control mechanisms such as pyramids, dual-class shares or cross-holdings (see e.g., Baumol et al. (2007) and Mueller (2003) for reviews). Despite the importance of corporations for economic activities, there are significant differences across the world regarding how corporate governance institutions are designed, and there is no consensus as to what is the best governance system. In some countries, corporate ownership and control is dispersed, and management is at arms-length from the owners, e.g., the US, whereas some governance systems display strong links between the management and one or a few controlling owners. These institutional differences are also reflected in differences in how the capital markets are organised and how they work. In some countries, banks, for example, play a more prominent role (e.g., Germany and Japan), whereas other countries rely more on equity markets (e.g., the US). The question discussed in this paper is what

the implications of these corporate governance differences are for entrepreneurship and economic dynamics.

Concentration of economic activities to a relatively few very large companies is in many ways a consequence of policies based on the belief that economic activities would gradually become dominated by ever larger firms. Schumpeter for example, in his early work, emphasised the role of the entrepreneur as a critical factor for economic development and the introduction of new innovations (Schumpeter, 1934). Whereas in his later work, Schumpeter came to believe that much of the radical innovations introduced by entrepreneurs would become replaced by incremental but systematic innovations made by large firms (Schumpeter, 1943). The former view has sometimes been labelled as Schumpeter mark 1 and the latter as Schumpeter mark 2. The latter view became very influential in many countries in the post war period (see Henrekson and Jakobsson, 2001, for a discussion how these views came to influence industrial policy in Sweden). For a more thorough discussion of these two views of economic development and their implications for economic policy, see Mueller (2003).

However, studying the largest global corporations imparts that the composition of corporations does not remain stable over time. In an analysis of the 500 largest global corporations, Philippon and Véron (2008) demonstrate that there is a significant difference across countries in the number of new large corporations that have emerged over recent decades. Their analysis exhibits that Europe has contributed 12 new corporations to the list of the 500 largest from 1950 until 2007, whereas the USA added 52 new ones. Since 1975, only one new European corporation has made it to the list whereas 26 are Californian. Fogel et al. (2005) find that a large turnover of the largest

corporations in a country is associated with a higher economic growth. This appears to suggest two things: 1) The corporate structure for even very large firms is not fixed; 2) there is a significant variation across the world in the number of new corporations that are growing to be very large. This raises question as to what factors can explain these variations:

1. Do the differences in corporate governance institutions explain the different number of corporations that are growing to be very large?
2. Are these institutions influencing entrepreneurship and new firm formation? Do, for example, the relatively frequent and extensive bureaucratic procedures and costs, while launching a new enterprise or in the cases of succession or when a renewal occurs, contribute to the hesitation among potential entrepreneurs?
3. What are the implications for resource allocation and long run economic development? One example of potential impacts is a capital flow from one continent to another.

In the following, we primarily focus on the second research question. This, in turn, is conducted relying on figure 1, dealing with the impact of corporate governance institutions on financial markets and the ownership structure. Furthermore, the influence of the latter two on entrepreneurship activities is also included in the figure, and the resulting impact on economic development.

Corporate governance institutions may be conservative or supportive of entrepreneurship, creative destruction and new firm formation.

Corporate governance has been defined in a number of ways. Here, we mention two contributions, one which is very general and another with a detailed approach: The first is by Shleifer and Vishny (1997): *"(...) the way in which suppliers of finance to corporations assure themselves of getting a return on their investment"*.

The other definition is a contribution by the OECD (1999): *"(...) the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions in corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance"*. Without exploring the details, we tend to rely on this latter definition.

The remainder of this chapter is organised in four sections. In the next section, we review the literature on corporate governance and entrepreneurship, followed by a section dealing with property rights, corporate governance and investments. Additionally, one section offers data from the field and some findings, followed by the conclusions.

Corporate governance and entrepreneurship

This chapter address the question of how corporate governance institutions interact and influence entrepreneurship and how this ultimately affects economic development. Such institutions set the framework conditions within which primarily incumbent firms and their owners act, which in turn have significant implications for how firms are governed

and ultimately how capital is (re)allocated. Corporate governance institutions display significant variations across the world, and much research in the economic literature suggest that these differences are important determinants of the long-run economic performance of countries. One noticeable feature that differs across the world is corporate ownership and control. Some countries, such as the US, have a relatively dispersed corporate ownership structure, whereas corporate control is much more concentrated in other countries. These differences have been found to be important determinants of the economic performance of countries.

The economic effects of these differences in the economic systems have been subject to a significant debate, and the literature on corporate governance is vast. For reviews of corporate governance literature, see Shleifer and Vishny (1997).

The *raison d'être* for the corporation is to supply financial capital to firms, which are too large for an individual or group of individuals to be able or willing to supply the capital. In corporations, ownership is often separated from control, which gives rise to a wide array of agency and information problems, which must be overcome for capital to be (re)allocated efficiently. Across the world, different institutional solutions have emerged to address these issues.

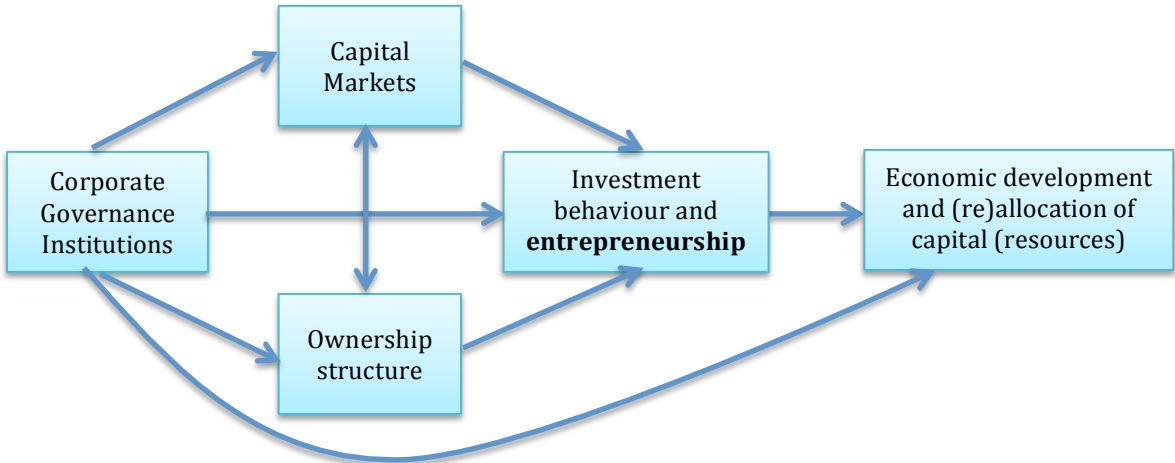
Berle and Means' (1932) classical book fixed the picture of the public corporation as being increasingly managed by professional managers and the large number of shareholder each having weak incentives to monitor them. The authors, however, described the American corporation as merely one out of many possible forms of corporate capitalism (see Morck et al. 2005, for discussion).

Outside of the US, corporations are primarily controlled by large dominant owners, and often the protection of investors is weak (La Porta et al., 1999). In fact, in most countries, companies are controlled mainly by wealthy families (Morck et al., 2005).

Furthermore, there is a long-standing controversy as to what corporate governance institutions are the most efficient in promoting economic progress. For discussion of this, see Roe (1993) and Denis and McConnell (2003).

Around the world, many different corporate governance institutions have arisen. Naturally, a wide range of varying factors, such as political and legal origin, drives differences between these. The research on such institutions and their economic consequences is extensive. However, in the literature, one can identify some stylised facts that can be used to categorise corporate governance institutions. The purpose of this section is to test our reasoning, on the links between corporate governance and entrepreneurship, and present some tentative findings with respect to these links. These are schematically illustrated in figure 1.

Figure 1: Corporate Governance, Entrepreneurship and Economic Development



Adopted from Mueller (2003)

Under most circumstances, we can expect corporate governance institutions to influence financial markets, ownership structure and composition, investment behaviour, entrepreneurship and ultimately economic development. These links are illustrated schematically in the figure above. It is, however, plausible to expect that there are feedback loops (see Williamson 2005 for a discussion of how institutions change through feedback). As mentioned above, corporations can employ various control-enhancing mechanisms, such as dual-class shares, pyramids and cross-holdings. Other institutions, such as banks, are allowed to be involved with firms that they lend money to and the extent to which minority investors are given legal protection. These institutions determine both how capital markets work and the structure of ownership. Family control of firms is, for example, supported by control enhancing mechanisms. In countries with strong protections of minority investors and high level of property rights protection, aggregate ownership concentrations are lower (Desai and Eklund, 2014). The structure of capital markets and ownership will in turn influence firm dynamics and entrepreneurship, which ultimately has consequences for the economic development of a country. If, for example, the capital markets and the ownership structure are less conducive to structural change, this may result in lower economic growth.

Property rights, corporate governance and investments

The corporation and entrepreneurship

Schumpeter (1942) believed that the corporation would become so successful that large firms could dominate modern capitalism and that this ultimately would lead to socialism

replacing capitalism¹. These ideas shaped political visions in many countries and industrial policies were designed to support large-scale industrial production.

The ideas also influenced how corporate governance institutions developed. For an analysis of the Swedish corporate governance model and Schumpeter, see Henrekson and Jakobsson (2001). The early contribution of Schumpeter (1934) emphasises the importance of the entrepreneur for introducing new innovations and thereby creating new firms and even industries. In later work, Schumpeter argued that innovations had become “routinized” and was being performed internally by large firms and this would lead to ever-larger firms with large-scale production. Many economists, in particular during the first half of the 20th century, believed that modern industrial production would become dominated by a few very large corporations (see for example Galbraith (1967)).

Corporate governance, investments and entrepreneurial finance

In a recent study by Eklund and Desai (2014), the relationship between the concentration of ownership and the functional efficiency of capital markets is investigated for a sample of 44 countries. They measure this efficiency by estimating the elasticity of the capital stock of firms with respect to output. Furthermore, they find that (re)allocation of capital is negatively influenced by the level of concentration of corporate control. These findings are consistent with the economic entrenchment hypothesis of Morck et al. (2005).

Baumol et al. (2007) distinguish between four categories of capitalism:

¹ In contrast to Marx, Schumpeter believed it was the superior performance of capitalism that would lead to its demise.

- 1) State-guided capitalism, *“in which governments try to guide the market, most often by supporting particular industries that it expects to become “winners””*;
- 2) Oligarchic capitalism, *“in which the bulk of the power and wealth is held by a small group of individual and families”*;
- 3) Big-firm capitalism, *“in which most significant economic activities are carried out by established giant enterprises”*; and
- 4) Entrepreneurial capitalism, *“in which a significant role is played by small innovative firms”*.

The authors emphasise that the only common feature of these systems is the recognition of property rights. Beyond this, the authors argue that the systems are very different and that this is reflected in very different growth performance. Furthermore, the differences on growth record can be attributed to how the *“(…) mechanisms of growth, innovation and entrepreneurship vary”* (Baumol et al., 2007).

In contrast to these authors, we argue that one of the key differences between these stylised types of capitalism is to be found in corporate governance institutions. We also argue that property rights are key features that distinguish these different institutions. These are a key determinant of how the industrial and corporate structure evolves over time, and this has ultimately important implications for long run economic development.

The core problems of corporate governance is how to monitor and incentivise current management and govern incumbent corporations and ultimately overcome agency problems arising from the separation of ownership from corporate control. In a way, corporate governance addresses the status quo: the current corporate structure.

Entrepreneurship, however, is about challenging current corporations and firms, i.e., it challenges the status quo through creative destruction.

Evidence from the field

Data

To illustrate the empirical relevance of the links illustrated in figure 1, we make some very simple analysis with cross-country data, which have been collected from a number of different secondary sources. We do not claim that we make a novel analysis or complete analysis, but we employ these data to illustrate and support the findings in the literature on corporate governance and entrepreneurship. For our purposes, we need data on the different components in figure 1. As measures of *corporate governance institutions*, we utilise two different institutional measures. First, we use the quality of property right protection as a measure of basic institutions that may either be supportive or disruptive to economic activity. We use the property rights index from the Heritage Index of Economic Freedom. The index ranges from 1 to 5, where a higher value indicates weaker protection of property rights.

As a proxy for *entrepreneurial activity*, we utilise entry data, which has been collected from the World Bank world development indicators and measures the number of new firm registrations per 1,000 working age inhabitants. Entry data are averages for 2004 to 2011 (or for available years during that period). There are a number of countries that have entry rates that are significantly higher than other countries. To address this, we exclude two countries that have entry rates beyond two standard deviations (Hong Kong and New Zealand). All the data can be found in appendix 1.

What does the data tell us?

The data described above can serve as a way of illustrating the links described in the schematic figure 1 above. First, let us look at the correlations. The correlation presented in table 1 corresponds fairly accurately to what one would expect given the relationships as described in figure 1 above.

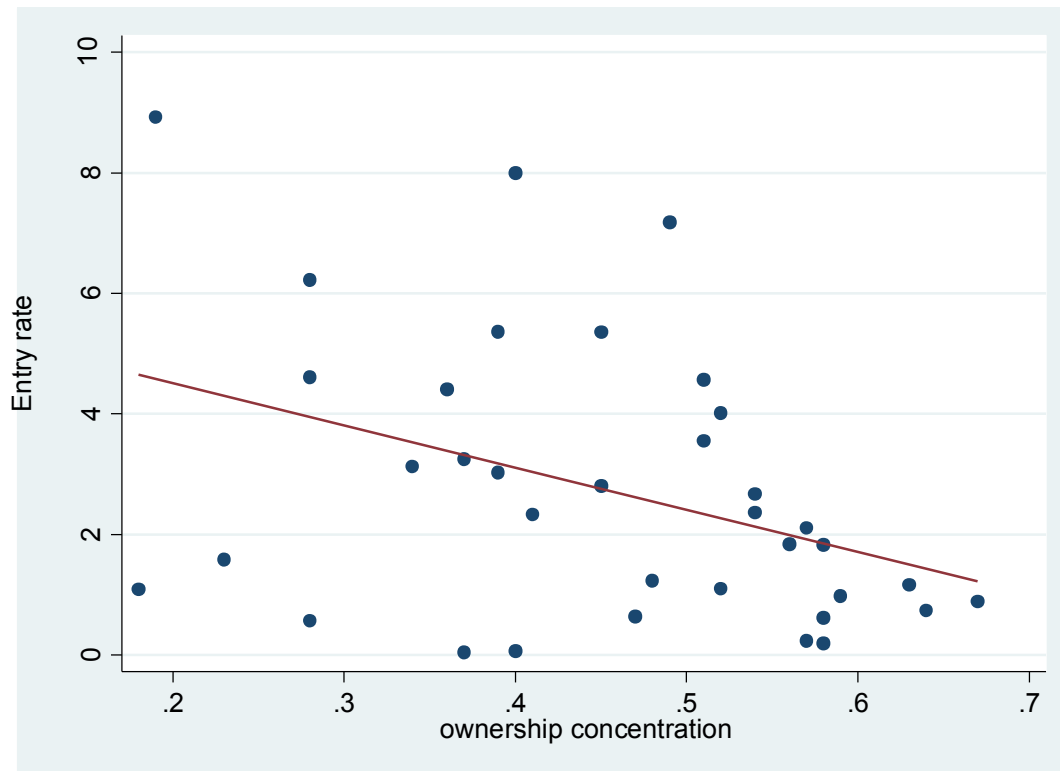
Table 1 Correlation matrix

	Entry	Ownership concentration	External capital/GNP	Domestic firms/capita	Allocation of capital
Entry	1				
Ownership concentration	-0.39*	1			
External capital/GNP	-0.29**	-0.28**	1		
Domestic firms/capita	0.62*	-0.14	0.25	1	
Allocation of capital	0.33*	-0.23	-0.13	0.02	1
Property rights	0.59*	-0.45*	0.15	0.39*	0.54*

* and ** indicate significance at 5 and 10 percent, respectively.

From figure 2, it is clear that we can observe a negative relationship between entry rates and the concentration of corporate ownership.

Figure 2, Entry rates and concentration of corporate ownership



*From this plot, countries with entry rates above two standard deviations have been excluded (Hong Kong and New Zealand).

As an indicator of *ownership structure*, we employ the mean value for ownership concentration for the three largest corporations in each country. These data have been collected from La Porta et al. (1998).

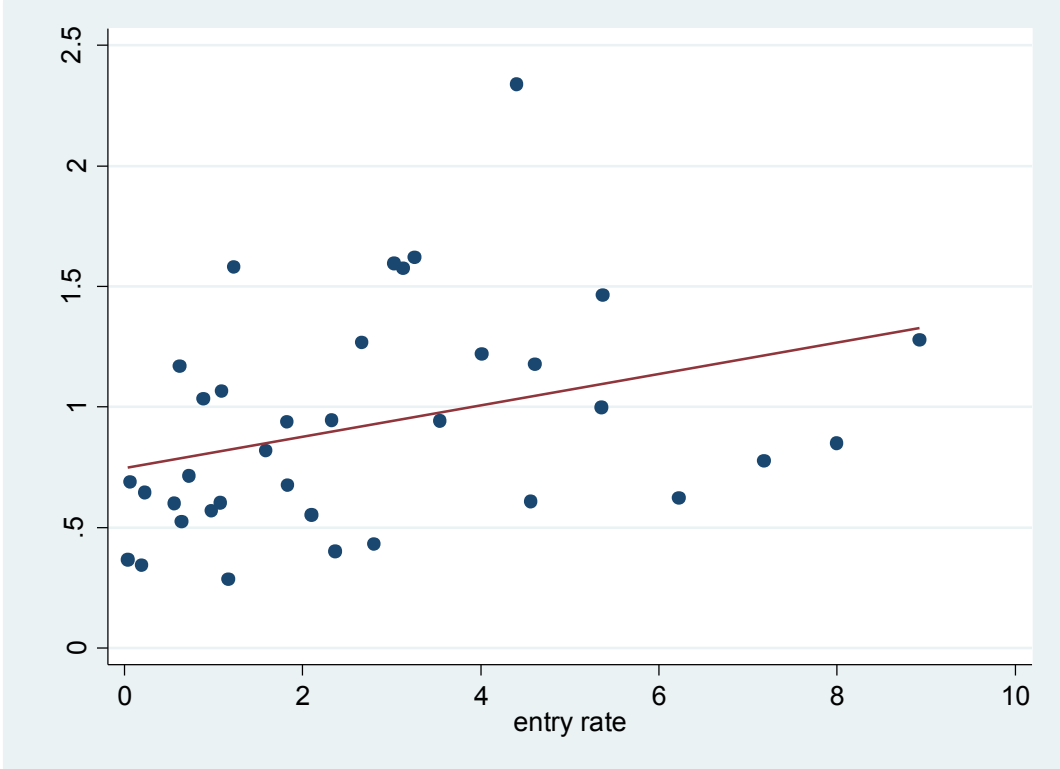
The measure of *capital allocation* (functional efficiency of capital markets) has been collected from Desai and Eklund (2014)². They measure the functional efficiency of capital markets by estimating the elasticity of the capital stock with respect to output, which provides an indicator of how swiftly resources are (re)allocated when the supply and demand condition of incumbent firms changes. As a measure of the size of capital

² Desai and Eklund (2014) estimate the elasticity of the capital stock with respect to output employing firm level observations from 44 countries. The basic model they estimate is: $\frac{I_t}{K_{t-1}} = \delta + \lambda \frac{\Delta Y_t}{Y_{t-1}}$ where I , K and Y represent investments, capital stock and output, respectively. λ is the elasticity of the capital stock with respect to output. This relationship can easily be derived from the accelerator principle and the assumption of proportionality between output and the capital stock ($K = kY$, where k is a capital coefficient).

markets, we employ external capital to GNP, which has been collected from La Porta et al. (1997), who also provide information on the number of firms per capita.

In figure 3, we can see that there is a positive relationship between entry rates and how efficiency capital is (re)allocated.

Figure 3, Entry rate and (re)allocation of capital



*From this plot, countries with entry rates above two standard deviations have been excluded (Hong Kong and New Zealand).

Regression analysis

To empirically verify the connections between the linkages illustrated in figure 1, we present some simple regression models below. We limit our analysis to factors influencing entrepreneurship (approximated by entry) and (re)allocation of capital. Furthermore, we do not claim to make an exhaustive empirical analysis of all factors

that may be of importance. The analysis should rather be viewed as confirmatory. As noted above, the other linkages have been more extensively studied in the literature. In table 2 below, we examine how entry rates are influenced by concentration of corporate ownership, the size of capital markets and by the quality of property rights. As we can expect, the variables of both ownership concentration and the size of external capital markets to be influenced by the quality of property rights are added stepwise. Entry also displays a fairly strong correlation with the number of firms per capita (table 1), which is consistent with the idea that countries that have an oligarchic capitalistic system or big-firm capitalism tend to have fewer firms, i.e., more concentrated corporate power.

Table 2, Regression results: Entry

Independent variables	Dependent variable: <i>Entry</i>		
Ownership concentration	-6.99** (-2.46)	-6.12** (-2.13)	-2.02 (-0.72)
External capital		1.36 (1.36)	1.19 (1.35)
Property rights			1.34* (3.25)
Constant	5.90* (4.42)	4.98* (3.35)	5.72* (4.30)
No. obs.	36	36	36
R ²	0.15	0.20	0.40
VIF	-	1.05	1.21

*, ** and *** indicate significance at 1, 5 and 10 percent, respectively. All estimations are made with OLS. T-values are reported in brackets. The property rights index has been inverted in all cases to facilitate interpretation.

We find that countries with highly concentrated corporate ownership have lower rates of entry. This effect becomes insignificant once we control for the quality of property rights. This finding is consistent with the interpretation that there is a trade-off between ownership concentration and property rights. The findings are also consistent with the economic entrenchment hypothesis of Morck et al. (2005), which suggests that countries

with weak institutions and highly concentrated corporate ownership may become economically entrenched. This, in turn, suggests that countries with poor institutions, highly concentrated corporate ownership and low entry rates would have poorer functional efficiency in (re)allocation of capital.

As a next step, we examine how (re)allocation of capital is affected by our key variables. In a competitive environment, firms will adjust their production capacity to changes in supply and demand conditions. This should be reflected by how swiftly incumbent firms adjust their capital when output increases or decreases.

In a perfectly competitive and frictionless (no capital stock adjustment costs) condition, we would expect the elasticity of capital stock with respect to output to be equal to one, i.e., a one percentage point change in output results in a one percentage point change in the capital stock.

Table 3, Regression results: (re)allocation of capital

Independent variables	Dependent variable: <i>(re)allocation of capital</i>			
Entry	0.07** (2.06)	0.01 (0.18)	0.01 (0.18)	0.02 (0.52)
Property rights		0.27* (2.82)	0.27* (2.64)	0.26** (2.59)
Ownership concentration			0.01 (0.01)	-0.12 (-0.19)
External capital				0.29 (1.50)
Constant	0.75* (6.59)	1.41* (5.48)	1.41* (4.05)	1.52* (4.36)
No. obs.	36	36	36	36
R ²	0.11	0.28	0.28	0.33
VIF	-	1.52	1.52	1.45

*, ** and *** indicate significance at 1, 5 and 10 percent, respectively. All estimations are made with OLS. T-values are reported in brackets. The property rights index has been

inverted in all cases to facilitate interpretation. Allocation of capital is measured as the elasticity of the capital stock with respect to output. See Desai and Eklund (2014) for details.

Loving to be independent and having a bold and adventures attitude are often claimed to be the major factors behind the willingness to start or reinvigorate a corporation. However, the environment in which a business is developed also can be an enhancing or hampering factor, e.g., corporate governance institutions. Thus, there are convincing reasons to focus entrepreneurial research on, for example, the legal prerequisites.

Policy makers have solid reasons to, via statutes, enhance opportunities for entrepreneurs. If research can, for example, show that the starting capital for a limited business does not legally need to be one million USD; in fact, if it can be sufficient with zero or just a few thousand dollars, or that micro businesses are not in need of a legally required annual meeting, board or deputy CEO, the bureaucratic and/or financial impediments can be eased. That will additionally contribute to avoiding hesitance because of time consuming administrative procedures and costs among practitioners.

Conclusions

This paper reviews the literature on the linkages between corporate governance and entrepreneurship and how corporate governance systems may be conducive or obstructive to entrepreneurship and economic development.

We employ cross-country data to illustrate how corporate governance institutions (as measured by property rights and concentration of corporate ownership) may influence the entry of new firms and the efficiency of capital allocation. As a measure of how

efficiently capital is (re)allocated in an economy, we utilise a measure of the elasticity of the capital stock with respect to output. Our findings support the view that weak protection of property rights and investors and high aggregate ownership concentration are negative factors for resource allocation and new firm formation. Ownership concentration and weak institutions reduce new firm formation.

Looking ahead toward future research, we emphasise the importance of the legal impediments for entrepreneurial activities. Any change that can suppress bureaucracy and costs without drawbacks for a third party (e.g., creditors) would be a welcome contribution. If research could exhibit such impediments, it should give inducements for policy makers (perhaps after lobbying activities) to act to enhance the entrepreneurial environment for practitioners.

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Appendix 1, Corporate governance indicators, entry and allocation of capital

Country	Ownership Concentration	Property rights	External capital/GNP	Entry	(re)allocation of capital
Argentina	0.28	2.73	0.07	0.56	0.600
Australia	0.28	1	0.49	6.22	0.621
Austria	0.58	1	0.06	0.62	1.167
Brazil	0.57	3	0.18	2.10	0.551
Belgium	0.54	1	0.17	2.66	1.266
Canada	0.4	1	0.39	8.00	0.849
Chile	0.45	1	0.8	2.80	0.431
Colombia	0.63	3.36	0.14	1.16	0.283
Denmark	0.45	1	0.21	5.36	0.997
Finland	0.37	1	0.25	3.25	1.619
France	0.34	2	0.22	3.13	1.575
Germany	0.48	1	0.13	1.23	1.579
Greece	0.67	2.36	0.07	0.88	1.034
Hong Kong	0.54	1	1.18	19.59	0.756
India	0.4	3	0.31	0.07	0.687
Indonesia	0.58	3.45	0.15	0.19	0.342
Ireland	0.39	1	0.27	5.37	1.464
Israel	0.51	2	0.25	4.56	0.609
Italy	0.58	2	0.08	1.83	0.937
Japan	0.18	1.36	0.62	1.08	0.603
Malaysia	0.54	2.45	1.48	2.36	0.400
Mexico	0.64	2.91	0.22	0.73	0.715
New Zealand	0.48	1	0.28	20.29	0.829
Norway	0.36	1.18	0.22	4.41	2.340
Pakistan	0.37	3.18	0.18	0.04	0.367

Peru	0.56	3.45	0.4	1.83	0.675
Portugal	0.52	2	0.08	4.01	1.219
Singapore	0.49	1	1.18	7.18	0.776
South Africa	0.52	2.91	1.45	1.09	1.064
South Korea	0.23	1.27	0.44	1.58	0.817
Spain	0.51	2.27	0.17	3.54	0.942
Sweden	0.28	1.64	0.51	4.61	1.177
Switzerland	0.41	1.27	0.62	2.33	0.946
Taiwan	0.18	2.09	0.88	N.a.	0.725
Thailand	0.47	1.36	0.56	0.64	0.523
The Netherlands	0.39	1	0.52	3.03	1.595
The Philippines	0.57	2.73	0.1	0.23	0.645
Turkey	0.59	2.36	0.18	0.97	0.567
United Kingdom	0.19	1	1	8.92	1.276
United States	0.2	1	0.58	N.a.	1.160



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