Measures of Country Governance

There are many aspects to good governance and therefore no simple yardstick of the quality of governance. However, in an update of the earlier paper by Laporta et al, Djankov, Laporta, Lopez-de-Silanes, and Shleifer construct two indexes of the quality of governance in different countries.[1]

For the first index, they argue that a poor governance system is one that (1) makes it difficult for shareholders to vote by proxy, (2) imposes onerous proof of ownership requirements for voting shareholders, (3) requires each shareholder to cast all her votes for one candidate for the board, (4) does not protect minority shareholders against oppressive actions by controlling shareholders, (5) does not provide shareholders with pre-emptive rights to buy new issues of stock, and (6) restricts the rights of shareholders to call an extraordinary meeting. Djankov et al measure the extent to which countries permit these restrictions on shareholder rights, and they then combine the results into a single index of "anti-directors' rights." The first column in the following table shows the index for a sub-sample of the 72 countries analysed by Djankov et al. A low value of the index (dark shading) indicates a country that permits many of these restrictions on shareholder rights.

A second indication of a good governance system is that it protects shareholders against self-dealing or tunnelling by the management or by a controlling shareholder. To measure the degree of protection that each country affords, the authors propose a hypothetical self-dealing transaction and assess the barriers that each country imposes on that transaction. The self-dealing index, shown in the second column of the table, summarizes the extent of the barriers that must be overcome. Again, a low value of the index (dark shading) indicates a country that imposes few restrictions on self-dealing.

The final column of the table provides a measure of stock market development. Healthy stock markets require good governance systems in which investors have control rights and are protected against self-dealing. Those countries with poor governance systems tend to have poorly developed markets.

Following the earlier paper by Laporta et al, Djankov et al argue that common law systems both provide better protection for investors and encourage the development of stock markets. The final rows of the table average the measures of governance and stock market development for the total sample of countries.

[1] S. Djankov,, F. Lopez-de-Silanes, R. La Porta, R., and A. Shleifer,, "The Law and Economics of Self-Dealing," *Journal of Financial Economics,* 88 (June 2008), pp. 430-465.

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	Anti-directors' rights index	Self-dealing Index	Stock Market Capitalization as Percentage of GDP
Argentina	3	0.44	58.1
Australia	4	0.79	102
Belgium	2	0.54	67.2
Brazil	5	0.29	38.4
Canada	4	0.65	106.2
China	1	0.78	43.3
France	3	0.38	89.5
Germany	2.5	0.28	54.7
India	5	0.55	33.8
Indonesia	4	0.68	24.7
Italy	2.5	0.39	52.8
Japan	3.5	0.48	69.2
Korea	3.5	0.46	54.1
Mexico	3	0.18	21.9
Netherlands	3	0.21	131.7
Pakistan	4	0.41	14.3
Russia	5	0.48	33.2
Singapore	5	1.00	164.8
South Africa	5	0.81	155.8
Spain	5	0.37	79.9
Sweden	3.5	0.34	112.3
Switzerland	3	0.27	249
UK	5	0.93	157.7
USA	3	0.65	142.1
Venezuela	0	0.09	5.5
Averages:			
Common-law countries	4.29	0.67	85.5
Civil-law countries	2.88	0.36	48.6
World	3.29	0.45	59.4

Light shading indicates that the country scores highly on the measure of governance or market development. Averages are calculated for a sample of 72 countries.

Source: S. Djankov, F. Lopez de Silanes, R. La Porta, A. Shleifer, "The Law and Economics of Self-Dealing" (December 2005). Available at SSRN: http://ssrn.com/abstract=864645 or http://dx.doi.org/10.2139/ssrn.864645.