Corporate governance and innovation: 
the dark side of shareholder protection

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ABSTRACT

Most of the “law and finance” literature argues that national legal rules protecting small investors positively affect long-run performance of countries, by boosting the stock markets. In this paper, I empirically challenge this argument, by focusing, in particular, on country innovation performance, which is central to the long-term development of market economies.

It is true that the risk of expropriation at the expenses of individual stockholders is likely to occur as a consequence of block-holder discretion where corporate law is weak in providing small investors with formal legal means of control. However, an increased minority shareholder protection may merely replace one set of problems with another. Indeed, nothing ensures that the small shareholders will not use their increased power to siphon off benefits for themselves. Minority shareholders, such as hedge funds and mutual funds, often hold pools of assets across a wide variety of investment strategies in different corporations and are less likely to take interest in long-term corporate results than those who have their wealth disproportionately invested in a given company. Knowledge intensive productions, in particular, may result negatively affected by strong minority shareholder protection, since the high specificity of the investments necessary to innovative activities exposes undiversified shareholders to opportunistic actions of small and (extensively) diversified stockholders, causing ex-ante incentive distortion in corporate investment strategies. Such a phenomenon is likely to be relevant even at the country-level, given increased shareholder activism by highly diversified institutional investors, who currently are showed to control more than 50% of outstanding shares traded on all major exchanges.

I perform three-stage panel and cross-section estimation using data over the 1993-2006 period and find that countries with stronger shareholder protection show larger market capitalization but also lower innovation activity, after controlling for those variables that are commonly advocated to strongly affect country innovation performance. How the stock market influences corporate innovation activity is also discussed.

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