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The Government as Institutional Entrepreneur in Corporate Governance Reform

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ABSTRACT

Governments around the world have become prolific issuers of soft law regulation in the form of corporate governance codes. However, the strategies that governments pursue to ensure the diffusion of the codes have remained unexplored in the literature. Drawing from institutional and socio-political perspectives, I hypothesize that governments pursue a combination of different intervention strategies to bring the corporate governance arrangements of firms in line with the issued code. These strategies focus on the mobilization of material resources, the dissemination of rationales and legitimating accounts for corporate governance change, interventions in social structure and the establishment of new social relations. I test my hypotheses in the context of the issuance of the national corporate governance code in Germany and find general support for my hypotheses.

Keywords: Code of Good Governance, Corporate Governance Regulation, Institutional Change.

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I. Introduction

This research aims at improving our understanding of the government's regulatory and non-regulatory intervention strategies in firms' corporate governance and is particularly important and timely in the light of the increasing government involvement in the corporate governance of firms in many transition as well as in developed economies (Coglianese *et al.*, 2004; Xie *et al.*, 2021). Due to high profile corporate scandals and economic and financial globalization pressures, many governments seek to reestablish public confidence in firm accountability and to provide investor friendly law regimes, capital market listing standards, and regulations that promote corporate governance best practices (Aguilera & Cuervo-Cazurra, 2009; Chey, 2007; Coffee, 2002). While the government may be limited in changing systems of path-dependent corporate rules (Bebchuk & Roe, 2004), government commissions and ministries around the world have become prolific issuers of soft law regulation in the form of corporate governance codes (Aguilera *et al.*, 2009; Cicon *et al.*, 2012). Corporate governance codes can principally be distinguished from hard corporate law in that they are formally non-binding, essentially self-regulatory and voluntary in nature (Seidl, 2006). These codes are "... a set of best practice recommendations regarding the behavior and structure of a firm's board of directors issued to compensate for deficiencies in a country's corporate governance system regarding the protection of shareholders' rights" (Aguilera & Cuervo-Cazurra, 2004, p. 415). As such, these codes may stand at odds with prevalent hard-corporate law and lead to increasing complexity and heterogeneity within corporate governance systems. For example, in the German context, the Government Commission for a German Corporate Governance Code, that was appointed by the Federal Ministry of Justice to develop an official national corporate governance code, recommended that the remuneration of all management and supervisory board members shall be reported individually and subdivided according to components, while, at the same time, accounting rule 285/#9 of the German Commercial Law states that firms must disclose only the aggregated sum of board members in total, with no information on the arrangement of rewards or on the pay of individual directors (http://norm.bverwg.de/jur.php?hgb, 285). What strategies does the government pursue to institutionalize those corporate governance codes?

II. Literature Review

The government, as an agent of the state and as a regulator of economic exchanges, plays a dominant role in shaping the institutional framework within which firms operate (North, 1990; Mees & Smith, 2019; Russo, 2001). With the issuance of different types of law, the government can affect corporate governance through regulatory means (Aguilera, Cuervo-Cazurra, & Kim, 2009; La Porta *et al.*, 2002; LaPorta, Lopez-de-Silanes *et al.*, 1998, Teng *et al.*, 2018) and impose coercive pressures on firms (DiMaggio & Powell, 1983). While studies in the institutional tradition focus on the government as a regulator of business activities, from a socio-political perspective, the government can also be characterized as a powerful firm stakeholder, who has particular interests, a political agenda, and pursues different intervention strategies to promote and achieve its economic and political goals in the interaction with firms (Yoshikawa *et al.*, 2007). The latter perspective is helpful in exploring how the government gets involved in the corporate governance process of individual firms in addition to its role

as a regulator. Several studies have considered the intervention strategies that the government as a stakeholder of firms pursues to achieve its goals. A large body of research has examined the effects of state ownership on firm performance outcomes (Delios *et al.*, 2006; Megginson & Netter, 2001; Toninelli, 2000). Other research has examined the benefits and costs of director ties between the government and firms (Faccio, 2006; Hillman, 2005; Nee *et al.*, 2007; Okhmatovskiy, 2010; Phan *et al.*, 2003). These studies suggest that the conceptualization of the government as merely a regulator of economic activity may be overly simplistic, and that the government may also exert non-regulatory influence on firms to realize its agenda. Recently, there have been calls for a more comprehensive examination of the government's role in firms' corporate governance (Okhmatovskiy, 2010). I respond to this call and suggest an integrated institutional and socio-political perspective as a suitable basis to examine the government's regulatory and non-regulatory influence on firms' corporate governance arrangements. Each of the two perspectives has the potential to complement the other. For example, the government may issue new regulation and thereby exert coercive influence over firms. However, coercion by rule-setting may not always ensure compliance and firms may pursue different avoidance strategies in response to these pressures (Oliver, 1991; Tolbert & Zucker, 1983). A socio-political perspective on government intervention in corporate governance adds that compliance pressures on firms to regulatory demands may be strengthened by the extent of formal, informal, individual, and organizational ties between the government and firms. A socio-political perspective can also benefit from considering factors emphasized by the institutional perspective. For example, non-regulatory intervention strategies pursued by the government to bring about change in the corporate governance of firms may be conditioned by the existence of legitimacy-enhancing dynamics for the government's demands firms' the institutional environment. Thus, I believe that an integration of institutional and socio-political perspectives may help in drawing a more comprehensive picture of government-firm interactions in the sphere of corporate governance.

III. Theory and Hypotheses

Although the issuance of corporate governance code recommendations may contest institutionalized governance practices that are anchored in prevalent corporate hard-law, the government lacks regulatory-coercive sanction and enforcement power to ensure that the corporate governance code best practices (i.e., soft law recommendations) it champions are widely adopted by firms. However, in absence of this regulatory-coercive sanction and enforcement power, the government may pursue different non-regulatory intervention strategies to deinstitutionalize established governance practices and bring about change in the corporate governance of firms that are in line with the promoted code. Since corporate governance is part of a nation's institutional framework I view changes in corporate governance as institutional change (Fiss & Zajac, 2004; Yoshikawa & McGuire, 2008; Yoshikawa *et al.*, 2007) and the government as a potential institutional entrepreneur who, after the introduction of new governance practices and the disruption of prevalent institutions, mobilizes and recombines resources, rationales, and social relations to bring about institutional change in the corporate governance of firms. Drawing from the literature of institutional entrepreneurship Hardy & Maguire, 2008), I hypothesize that the government pursues a combination of different non-regulatory intervention strategies to institutionalize corporate governance code best practices in an institutional field (Greenwood *et al.*, 2002; Lawrence, 1999; Pfeffer & Salancik, 1978; Phillips *et al.*, 2004; Rao *et al.*, 2003; Suchman, 1995). The intervention strategies fall in the following broad themes: (1) mobilization of material resources, (2) dissemination of rationales and legitimating accounts for institutional change, and (3) interventions in social structure and establishment of new social relations.

DiMaggio (1988, p. 18) pointed out the necessity of "sufficient resources" for institutional entrepreneurs to be able to bring about institutional change in a field. These resources include financial resources (Lawrence & Suddaby, 2006). Research suggests that these financial resources can be mobilized by institutional entrepreneurs and then used as a lever against other actors in the field to lobby and negotiate for cooperation and support for the intended change (Hardy & Maguire, 2008). I hypothesize that resource mobilization is a central intervention strategy for the government to reinforce regulatory intervention strategies and to promote institutional change (DiMaggio, 1988; Dorado, 2005; Lawrence & Suddaby, 2006; Pfeffer & Salancik, 1978), thus:

H_1: Government ownership in firms increases the likelihood that those firms adopt corporate governance code practices issued by a government code-issuing agency.

I hypothesize that the government pursues intervention strategies in the discursive and ideational realm to persuade firms to support its regulatory intervention strategies and thereby increase the chances of institutional change. Studies of theorization within institutional theory have examined how institutional entrepreneurs discredit the status quo in existing institutions and disseminate legitimating accounts to support institutional change or transformation (Lounsbury & Glynn, 2001; Phillips *et al.*, 2004; Rao *et al.*, 2003; Strang & Meyer, 1993), thus:

H_2: An increase of legitimating accounts for good corporate governance practices disseminated by a government code agency or its members increases the likelihood that firms adopt corporate governance code practices issued by a government code issuing agency.

I hypothesize that the government engages with firm representatives and seeks to coopt them to avoid conflict and hostile reactions toward regulatory innovation. The creation of a code agency, that calls on firm representatives to serve as members in the development of codes, can be considered a manipulation strategy in firms' social structure that may increase the legitimacy of the regulatory innovation and consequently increases the chances of institutional change (Lawrence, 1999; Oliver, 1991; Suchman, 1995), thus:

H_3: The cooptation of firms by a government code issuing agency increases the likelihood that those firms adopt corporate governance code practices issued by that government agency.

I hypothesize that the government's cooptation strategy, which leads to competitive patterns of value commitments within firms and thereby to firm internal pressures for institutional change, may be strengthened and enabled when those firms have resource dependencies on the government. These dependencies may shift decision-making power to those firm internal actors that are in favor of the change (Greenwood & Hinings, 1996; Pache & Santos, 2010), thus:

H_4: The effect of the cooptation of firms by a government code issuing agency on the likelihood that those firms adopt corporate governance code practices is significantly strengthened by higher government ownership in those firms.

I hypothesize that even in the absence of change enabling resource dependencies, the firm internal representation of the government's demands may be strengthened by the existence of rationales and legitimating accounts for institutional change (Greenwood & Hinings, 1996). The dissemination of text and rhetoric that specifies problems with existing governance practices and justifies the regulatory innovation as a solution to these problems may increase the intra-organizational legitimacy of the demands of the representatives of government's demands, shift decision-making power to those actors, and strengthens their role in the change process, thus:

H_5: The effect of the cooptation of firms by a government code issuing agency on the likelihood that those firms adopt corporate governance code practices is significantly strengthened by increasing legitimating accounts for good corporate governance practices disseminated by the government code issuing agency or its members.

IV. Methodology

A. Data and Sample

Since there exists no publicly accessible database with detailed corporate governance information for German firms listed on the Frankfurt Stock Exchange, the creation of a unique hand-collected panel data set became necessary. The data sources consisted primarily of archival data, including the individual firms' annual business reports, firms' annual declarations of conformity, OSIRIS provided by Bureau Van Dijk, Compustat, the website of the Frankfurt Stock Exchange, the Hoppenstedt Aktienführer and the Commerzbank "Wer gehört zu wem?" data CD. Since the regulatory environment of financial companies differs significantly from that of non-financial companies, companies included in SIC6 were excluded. The panel data was collected over the observation period beginning in 2002 and ending in 2006, resulting in a balanced dataset including 809 firm-year observations. I used a lagged data structure to examine my hypotheses, therefore, all independent and control variables were measured at time t-1. Since the code was issued in 2002, the data analysis was not compromised by left censoring.

B. Dependent Variable

The dependent variable was coded 1 if a German firm listed on the Frankfurt Stock Exchange firm published an individualized management board remuneration report, as recommended by the corporate governance code, at the end of year t, and 0 otherwise. This code provision was at odds with the traditional regulative, normative, and cognitive-cultural institutional pillars of the German corporate governance system and was therefore an appropriate outcome variable to test my hypotheses.

C. Independent Variables

Government ownership was measured as the ratio of a firm's outstanding shares held by the federal or state government. The data as updated annually and collected from Hoppenstedt Aktienfuehrer and cross-checked with the Commerzbank AG *Wer gehoert zu wem?* ownership data CD.

Legitimating accounts were measured as the total number of articles and commentaries in German flagship newspapers, trade journals, business magazines, academic journals, and other general business and interest papers that referenced the German corporate governance code commission or any corporate governance committee members on the issue of the German corporate governance code. The data was updated annually and was collected from LexisNexis.

Cooptation of firms by the government agency was measured as an indicator variable that was coded 1 if one or more directors of a firm's board sat on the Government Commission for a German Corporate Governance Code, and 0, otherwise. The data was updated annually over the course of the observation period.

D. Control Variables

I included several variables in the equations that have been shown to be linked to institutional change in firms' corporate governance arrangements. Those variables are: year dummies to capture increasing normative pressures for change, industry dummies, previous change in corporate governance arrangements (adoption of executive stock option program) as a proxy for openness to governance change, foreign sales and foreign listing to account for exposure to global pressures for change, free float to capture exposure to stock market pressures for change, firm age and firm size (log of assets) to measure a firm's centrality in the local economy, firm performance (log of ROA) to capture performance problems as triggers for reform, foreign board members to proxy the firm's exposure to international pressures for governance change, inside and corporate ownership (dominant ownership by German companies, banks, families, individuals, and their associated holdings and foundations) to capture the firm's embeddedness in the local context, dominant foreign/market ownership (to capture resource dependencies on actors outside the local context) and number of peer firms (within the firm's industry) that had adopted code provisions (to capture normative pressures for change) (Fiss, 2008; Fiss & Zajac, 2004; Sanders & Tuschke, 2007; Yoshikawa & Rasheed, 2010).

E. Method

I specified a competing-risk discrete-time event history analysis to test for the effects of the independent and control variables on the likelihood that a firm adopts the corporate governance code practice and estimated cluster robust standard errors (Allison, 1984). The regression model has the following form:

$$log[P(t)/(1-P(t)] = a(t) + b1x1 + b2x2(t) \qquad (1)$$

where log[P(t)/(1 – P(t)] represents the logarithmic odds of practice adoption occurring for a particular firm at any time t; a represents the baseline hazard of adoption occurring at any time t; $b1$ represents the change in the log-odds for each one-unit increase in a time-invariant covariate x1; and b2 represents the change in the log-odds for each one-unit increase in a time-varying covariate x2(t). Because there are multiple observations per firm, observations were not independent within groups, the cluster option in STATA was used to estimate robust standard errors.

V. Results

Table I, Table II, Table III, Table IV and Table V report small to medium correlations between the explanatory variables. The correlations do not indicate the existence of substantial collinearity problems (Variance Inflation Factors are all below 4.0).

TABLE I: Correlation Coefficients

1 Practice Adoption	1	2	3	4	5
2 Exe. Stock Options	0.11	–	–	–	–
3 Foreign Sales	0.02	0.10	–	–	–
4 Foreign Listing	0.09	0.13	0.20	–	–
5 Free Float	0.13	0.23	0.05	0.19	–
6 Firm Age	-0.04	-0.28	0.13	0.09	-0.25
7 Firm Size	0.10	-0.04	0.29	0.51	-0.03
8 Firm Performance	0.06	-0.14	0.14	0.02	-0.01
9 Foreign Directors	0.02	0.13	0.19	0.29	0.00

TABLE II: Correlation Coefficients

6 Firm Age	6	7	8
7 Firm Size	0.37	–	–
8 Firm Performance	0.10	0.19	–
9 Foreign Directors	0.09	0.30	-0.05

TABLE III: Correlation Coefficients

	1	2	3	4	5
10 Family Ownership	-0.11	-0.04	0.00	-0.18	-0.13
11 Corporate Ownership	-0.03	-0.15	-0.01	-0.14	-0.29
12 Foreign Market Ownership	-0.02	-0.11	0.04	0.06	-0.09
13 Industry Adoption	0.04	0.02	0.13	0.05	0.04
14 Gov. Ownership	0.07	0.00	-0.04	0.00	-0.06
15 Gov. Cooptation	0.09	0.09	0.13	0.42	0.05
16 Gov. Legitimating Accounts	0.07	0.02	-0.01	0.03	0.01

TABLE IV: Correlation Coefficients

	6	7	8	9	10	11
10 Family Ownership	0.00	-0.14	0.09	-0.15	–	–
11 Corporate Ownership	0.13	-0.04	-0.04	-0.07	-0.33	–
12 Foreign Market Ownership	0.00	0.04	0.03	0.24	-0.18	-0.13
13 Industry Adoption	0.02	0.01	0.14	0.03	0.00	-0.07
14 Gov. Ownership	-0.06	0.18	0.00	0.00	-0.13	-0.08
15 Gov. Cooptation	0.14	0.43	0.02	0.06	-0.12	-0.08
16 Gov. Legitimating Accounts	0.00	0.06	-0.01	0.07	0.00	-0.05

TABLE V: Correlation Coefficients

	12	13	14	15
13 Industry Adoption	0.08	–	–	–
14 Gov. Ownership	-0.02	-0.01	–	–
15 Gov. Cooptation	-0.03	0.00	-0.02	–
16 Gov. Legitimating Accounts	0.04	-0.01	0.00	0.05

Table VI presents the results of two regression estimations, which provide general support for my five hypotheses.

TABLE VI: Event History Regressions

	Control Model DV: Practice Adoption	Full Model DV: Practice Adoption
Year Control Variables	included	included
Industry Control Variables	included	included
Code Acceptance	0.693^{*} (2.46)	0.605^{*} (2.10)
Foreign Sales	0.405 (0.84)	0.415 (0.88)
Foreign Listing	0.343 (0.83)	0.364 (0.82)
Free Float	0.424^{*} (2.52)	0.476^{**} (2.68)
Firm Age	-0.00170 (-0.64)	-0.00172 (-0.65)
Firm Size	0.153^{*} (2.13)	0.113 (1.56)
Firm Performance	0.00527 (0.52)	0.00708 (0.68)
Foreign Board Members	-0.0433 (-0.14)	0.0671 (0.21)
Inside Ownership	-0.0219^{***} (-3.39)	-0.0185^{**} (-2.75)
Corporate Ownership	-0.00107 (-0.16)	0.00241 (0.34)
Foreign/Market Ownership	-0.0150 (-1.41)	-0.0129 (-1.20)
Industry (Peer) Adoption	0.0431^{*} (2.56)	0.0456^{**} (2.67)
[H1] Gov. Ownership	–	0.0267^{***} (3.31)
[H2] Gov. Cooptation	–	4.294^{*} (2.06)
[H3] Gov. Legitimating Accounts	–	0.00209^{*} (2.08)
[H1] x [H2]	–	0.0129^{+} (1.69)
[H2] x [H2]	–	0.686^{**} (2.91)

t statistics in parentheses; $^{+}p < 0.10$, $^{*}p < 0.05$, $^{**}p < 0.01$, $^{***}p < 0.001$.

VI. Conclusion and Limitations

Studies on the role of the government in an institutional change in corporate governance tend to characterize the government as an agent of business activities that imposes coercive pressures on firms via regulatory means (eg. Xie *et al.* 2021). However, the results of my research show that this is an overly simplistic view of the government as an agent of change. The government uses several non-regulatory strategies to influence firms' choices of corporate governance arrangements. This is an important finding because it provides evidence of a more active role of government in corporate governance reform. The government, as an institutional entrepreneur, strategically utilizes political, material, and social skills through a combination of resources, rationales, and social relations to bring about change in

corporate governance systems. The institutional theory provides a valuable theoretical lens to study the role and activities of the government in corporate governance reform.

My analysis focused on the role of the government in the German context. Future research will be challenged to test my hypotheses in different contexts, times, and with different corporate governance outcomes. While I am confident in my choice of independent variables in operationalizing my hypotheses, future research may choose different measures. For example, with respect to the competition hypothesis, a question could be: Are some directors more influential than others? With respect to the variable "legitimating accounts", future research could utilize survey or interview data to operationalize this variable.

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