CORPORATE GOVERNANCE: THE DEVELOPMENT CHALLENGE

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Developing countries face the challenge of transforming political and economic governance arrangements from relationship-based systems into rules-based systems. Many must enhance their ability to address corporate insiders' abusive use of schemes to expropriate or divert resources from other stakeholders. With enforcement at the heart of the challenge, the appropriate balance between regulatory and voluntary initiatives remains an open question.

Photo above: The Organization for Economic Cooperation and Development (OECD), meeting here at its Paris headquarters, sets global standards for transparent and accountable business practices. © OECD Photo

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Recent spectacular corporate governance failures in the United States and Europe remind us that such breakdowns can severely affect the lives of thousands—employees, retirees, savers, creditors, customers, suppliers—in countries where market economies are well developed. But is corporate governance important in the developing world, including so-called emerging-market and transition economies, where national economies tend to be dominated by large family-owned, state-owned, and/or foreign-owned companies that do not have shares widely traded on local stock markets and where a multitude of small noncorporate forms of enterprise often account for a significant proportion of local employment and output? Until recently, few people thought so.

Only after the financial crises of 1997-1999 in Asia, Russia, and Brazil did heightened concern for global financial stability draw attention to the problems of "crony capitalism" and poor corporate governance in some emerging-market economies. Since then, the perceived threat to global financial markets and the pressures engendered by that perception have waned. The danger is that local efforts to enhance corporate governance in the developing world will lose momentum as a consequence.

Instead, those efforts need to be strengthened. Research by the Organization for Economic Cooperation and Development (OECD) on the importance of local corporate governance for sustained productivity growth in the developing world, as well as the OECD's regional corporate governance roundtables in Asia, Latin America, Eurasia, Southeast Europe, and Russia, show that the quality of local corporate governance is critically important for the success of long-term development efforts throughout the developing world today.

Rules and Relationships

A country's system of corporate governance comprises formal and informal rules, along with accepted practices and enforcement mechanisms, private and public. Taken together, these govern the relationships between the people who effectively control corporations (corporate insiders) and those who invest in them. Well-governed companies with actively traded shares should be able to raise funds from noncontrolling investors at significantly lower cost than poorly governed companies because of the premium potential investors can be expected to demand for taking the risk to invest in less well-governed companies.

Corporate governance continues to be seen by some as relatively unimportant in developing countries, in large part because of the small number of firms there with widely traded shares.

The poor quality of local systems of corporate governance lies at the heart of one of the greatest challenges facing most countries in the developing world: how to successfully—often in the face of covert or overt resistance from powerful, locally entrenched interest groups—transform local systems of economic and political governance, including those of corporate governance, from systems that tend to be highly personalized and strongly *relationship* based into systems that are more effectively *rules* based.

In many of today's OECD countries, the transformation from predominantly relationship-based to rules-based systems of economic and political governance took place largely before the spectacular rise and rapid global spread late in the 19th century of the giant manufacturing corporation and the displacement of proprietary capitalism (unincorporated individually owned business) by global corporate capitalism.

Today's developing countries thus face a challenge unknown to many OECD countries: how to move from relationship-based to rules-based systems of governance at a time when large private- and state-owned corporations play significant roles in local economies (whether or not their shares trade actively in a local stock market) and therefore tend strongly to influence local systems of governance.

Oligopolistic Rivalry and Corporate Insiders

The importance and difficulty of this challenge are reflected in the pervasiveness of two often mutually reinforcing phenomena in the developing world. One is the considerable extent to which corporate insiders are able to manipulate the economic environment to extract financial income not matched by corresponding labor or investment. Insiders display a predictable reluctance to divulge information needed to measure the values of their corporations. Nevertheless, the difference between the price paid for a controlling bloc of a company's shares and the price others paid for the shares in the open market can be used as an objective indicator of those values. During the 1990s, the difference averaged 33 percent in Latin America and 35 percent in central European transition economies, for example, as contrasted with 2 percent in South Africa, the United States, and the United Kingdom, and 8 percent in non-Anglo-Saxon Europe.

The other phenomenon is the impact of oligopolistic rivalry among powerful interest groups entrenched in local structures of economic and political power. (An oligopoly is a market with so few suppliers that the behavior of any one of them will affect price and competition.) Such groups are sometimes called distributional coalitions because of their tendency to spend significant financial, physical, and human resources in attempts to defend and/or expand their bases for value extraction rather than invest resources in the creation of new wealth for their national economies and themselves. They generally include insiders in major private and public corporations.

Strategies of Ownership

Three techniques are widely used by insiders throughout the developing world to expropriate or divert resources from corporations in ways that deprive noncontrolling investors and other corporate stakeholders of wealth that would be considered their fair share in countries with sound corporate governance. Most important is the use of *pyramidal corporate ownership structures* in which one firm holds a controlling equity

share in one or more other firms (the "second layer"), each of which, in turn, holds a controlling share of one or more other firms (the "third layer"). Such pyramids allow insiders who control the company at the top to effectively control the resources of all the firms in the pyramid, even though their nominal ownership of all those other firms, especially in the lower layers, may be quite small.

Also important are *cross-shareholdings* (firms that possess each other's shares) and *multiple share classes* (shares in the same company that have different voting rights, with insiders' shares having disproportionately high voting rights). Used in combination, these techniques make it possible for corporate insiders to control corporate assets worth considerably more than their nominal ownership rights, or, in the case of managers, their nominal remuneration, would justify.

Corporate insiders' use of techniques to defend or enlarge their share of power vis-à-vis rivals also tends to reduce or eliminate the need to seek alternative means to access outside finance, notably through better corporate governance. These techniques offer dominant shareholder-managers, prevalent in much of the developing world, an added advantage from their perspective. Rather than having to dilute their control, as would occur with the sale of equity to raise funds from outside investors, they actually increase it, sometimes considerably, beyond their nominal ownership rights.

Unfortunately, these techniques also create strong incentives for corporate insiders to pursue abusive self-dealing and related activities with the sizable corporate resources they control. Not only do such activities constitute severe market distortions, but they lead corporations to behave in ways that significantly increase both rigidities and volatility in the local economy. In economies that lack abundant capital, they create strong incentives for corporations to invest heavily in capital-intensive facilities, which often remain underused. They provide incentives for corporate insiders to pursue strategic rivalry among themselves that costs society dearly in wasted resources and foregone opportunities for needed change.

Corporate insiders' widespread use of pyramidal ownership structures, cross-shareholdings, and multiple share classes thus goes far in explaining their tendency to resist pressures to improve corporate governance in many developing countries. It also goes far in explaining the severe waste, market distortions, and often massive misallocation of human and material resources associated with corruption and crony capitalism in too many of those countries.

What To Do?

The challenge for many developing countries is to break out of this vicious circle. Doing so requires better understanding of the importance of corporate governance for developing countries today.

The OECD has been working to increase this understanding through its Development Center's research and informal policy dialogue on corporate governance and through its regional policy dialogue programs in Asia, Latin America, Southeast Europe, Eurasia, the Middle East and North Africa, Russia, and China. By bringing together public sector decision makers, regulators, companies, investors, and other stakeholders in each region, these roundtables help build coalitions for reform. Policy discussions have revolved around the OECD's Principles of Corporate Governance, with each region developing recommendations adapted to local conditions, issued in the form of regional white papers.

High on the list of priorities for reform in many developing countries must be enhancing the capacity to address the problem of insiders' abusive use of multiple share classes, cross-shareholding, and pyramidal corporate control structures. In many countries, this will require significantly greater public disclosure of share ownership and stronger measures to ensure basic property rights of ownership for domestic and foreign minority shareholders.

The key challenge in many countries today is not so much how to design better corporate governance laws and regulations—many now have good ones on the books—but how to enforce them effectively. Many developing countries have too much and sometimes conflicting regulation that proves to be too difficult to enforce.

Adequate enforcement, which is at the heart of the challenge of moving from relationship- to rules-based systems of corporate governance, raises the issues of voluntary versus mandatory approaches and of the need for strengthened regulatory and judicial institutions to enforce them.

Enforcement Considerations

Many OECD countries favor an approach to regulation and enforcement that combines relatively high disclosure standards with considerable reliance on voluntary governance mechanisms. Debate is ongoing in

OECD countries as to an appropriate balance between regulatory and voluntary initiatives. For developing countries, further questions can be raised as to the effectiveness of voluntary mechanisms, given these countries' relatively weak institutions of rules-based governance and weak third-party monitoring capabilities. The large information gap from which corporate insiders benefit at the expense of public shareholders, especially in countries with concentrated ownership structures and poor protection of minority shareholders' rights, means that governments will continue to have a central role to play.

The role of regulatory and judicial institutions in public enforcement is particularly important for developing countries. Recent experience highlights the potential value for these countries of having a strong and politically independent, yet fully accountable, securities regulatory commission that is well funded and endowed with adequate investigative and regulatory powers. True for all countries, this experience is especially relevant for countries that have weak judicial systems, not least because of the considerable time it can take to strengthen a country's judiciary system.

Policymakers should not, however, perceive the choice between regulatory and judicial means of enforcement as an either/or choice; they should see those means as complementary and mutually reinforcing. From a long-term development perspective, few institutions are more important for sound rules-based governance and long-term growth in a country than a well-functioning judiciary. This is true not only because a country's corporate governance system comprises considerably more than its securities laws and their enforcement, including credible contract enforcement, but also because of the danger that those with responsibility to regulate, such as a securities commission, may be corrupted or unduly influenced by those whose actions they are intended to monitor and regulate. It is in countries most burdened by the behavior of powerful distributional coalitions, whose entrenchment is often reflected in a lack of national judiciary independence and accountability, that the risk of corruption or excessive influence tends to be greatest.

Developing a competent, politically independent, and well-funded judiciary is vitally important for enhancing the contribution of corporate governance to corporate performance and long-term national development.

The strong resistance to many of the changes needed to enhance corporate governance often asserts itself through relationship-based systems of public governance. The relative weakening or collapse of those systems in many countries in recent years may constitute a window of opportunity for countries to overcome resistance to changes that are needed as much in their systems of public governance as in those of corporate governance.

The broader point is not only that sound corporate governance requires sound public governance, but also that sound government today requires sound corporate governance. Given the power of corporate insiders and their close relationships with those who exercise political power at the highest levels, development requires simultaneous movement in the institutions of corporate and public governance from the rule of persons to the rule of law. ■

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