CHAPTER 1

Corporate Governance and Economic Development: The Nexus

1.1. Introduction

The corporate governance rhetoric is a familiar one. In a time of financial turmoil around the world, governing the modern corporation[1] has never been more important and has captured the attention of not only the companies themselves but also policy makers and reformers. Yet, it seems that the rhetoric glosses over the question of why corporate governance is of such general importance.

Two competing strands of thought exist. On the one hand, and at first glance, the importance of corporate governance to growth and development generally, and economic development in particular, is evident. On the other hand, corporate governance continues to be perceived as being of little importance for economic development. This is primarily due to two factors. First, is the widespread belief that corporate governance serves to protect the interests of shareholders from the misbehaviour of managers in large companies in which management is separate from ownership and shares are traded on stock markets,[2] and therefore, does not serve the interests of the public at large. Second, is the challenging question of the high levels of growth achieved by countries in continental Europe during the post-war period and in Asia in the 1990s while seemingly characterised by poor corporate governance.[3]

[1] The words 'corporations', 'companies' and 'firms' are used interchangeably.

[2] N Meisel, *Governance Culture and Development* (OECD Paris 2004), 7, 117.

[3] ibid; the high levels of growth are explained in the study as attributable to the systems of corporate governance that enabled the emergence and prevailing of a 'general interest', particularly among the elites, over the 'potentially conflicting' private interests of different factions of society.

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While it is now commonly accepted that property rights,[4] enforcement of contracts[5] and the rule of law[6] are significant factors for economic development, the question which remains to be answered is whether corporate governance and economic development are viewed by the literature as closely correlated as they seemingly appear to be. The question is also raised as to whether policy makers, analysts, international institutions and academics are on the right path in advocating corporate governance as a precondition for economic growth and development.

The objectives of this chapter are twofold. First, it seeks to understand the relationship between corporate governance and economic development. Second, it supports the primary thesis of this study that an analysis into the reform of corporate governance in developing countries should begin with a focus on local market structures that define the adaptation and effectiveness of corporate governance, by presenting a holistic and context-dependent approach to understanding the relationship between corporate governance and economic development.

This chapter seeks to understand the relationship between corporate governance and economic development by a rigorous review of the available evidence on corporate governance and economic development, and an investigation of the conventional wisdom among economists and development scholars that corporate governance is a necessary precondition for economic growth and development in both the descriptive and analytical accounts of the nexus between corporate governance and economic development. Thereafter, to support the thesis of this study, the argument is presented for a more holistic and context-dependent approach to the relationship between corporate governance and economic development.

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[4] H De Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (Transworld London 2001); World Bank, *World Development Report 2005: A Better Investment Climate for Everyone* (New York 2004), Chapter 4.

[5] D North, *Institutions, Institutional Change and Economic Performance* (Cambridge University Press Cambridge 1990); R Messick, What Governments Can Do to Facilitate the Enforcement of Contracts (2005), Public Sector Group World Bank, http://siteresources.worldbank.org/INTLAWJUSTINST/Resources/ContractEnforcementCairo.pdf [10 February 2008].

[6] D Kaufmann, A Kraay and M Mastruzzi, Governance Matters IV: Governance Indicators for 1996–2004 (2005), World Bank Policy Research Working Paper 3630, http://ssrn.com/abstract=718081 [5 March 2008]; K Dam, *The Law-Growth Nexus: The Rule of Law and Economic Development* (Brookings Institution Press Washington DC 2006).

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Section 1.2 of this chapter surveys the theory and evidence on the relationship between corporate governance and economic development and highlights the emerging consensus on the importance of corporate governance in economic growth and development. This section of the chapter underlines the accepted view among economists and development scholars that corporate governance is a necessary precondition for economic development, especially in the context of developing countries.

Section 1.3 seeks to support the argument that a more holistic and context-dependent approach is essential to understanding the relationship between corporate governance and economic development. The primary line of reasoning put forward to support this argument is that corporate governance cannot be viewed as an isolated and independent phenomenon distinct from the environment in which corporations operate, but rather that the success of corporate governance is contingent upon a number of legal, regulatory, political, and social institutions and market structures, and that therefore, the literature and the reform process needs to encompass such institutions and structures.

1.2. Corporate Governance and Economic Development: The Theory and Evidence

1.2.1. *Economic Development and Corporations*

The concept of development emerged in the post-World War II era and was closely identified with economic development and industrialisation. Through the historic link with industrialisation, corporations have always been directly connected to the development discourse. Over the decades the development discourse has greatly expanded and is now commonly understood to include social, political, cultural components in addition to the economic. As a result of this expansion, development is reframed in different ways such as human development[7] and sustainable development,[8] and it is widely stressed that development is much more than

[7] A commonly used index is the human development index, which draws on observed features of living conditions, such as life expectancy, literacy, educational attainment and GDP per capita.

[8] The 2005 UN World Summit Outcome refers to the pillars of sustainable development as economic development, social development and environmental protection. UN Adoption of 2005 World Summit Outcome (2005), A/RES/60/1.

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higher income.[9] Such reconceptualisations of development have significant implications for our understanding of the role of corporations in development, although it is with respect to the promotion of economic development that corporations play a key role.

In the year 1000, the rich countries of today were poorer than Asia and Africa at present.[10] In the half century from 1950 to 2000, the developed world grew roughly four times in real per capita income while the developing world grew threefold,[11] and yet in 2008 more than one billion people, one-sixth of humanity, live on less than 50 pence a day.[12] The eradication of this inequity is a key driver of development.

The modern corporation is one of the world's most powerful means for creating wealth and prosperity. However, to fulfil this role corporations must be properly governed. They must have responsible internal governance, operate within competitive markets and help create and support sound public governance structures.

In the years after World War II and during the first stage of development thinking, developmental emphasis was on the proposition that production was the function of both labour and capital. In the post-colonial period many developing countries associated development with industrialisation and adopted interventionist approaches to promote the goal of industrialisation. The first approach adopted in the development process is what became known as import-substitution industrialisation, where efforts were made to achieve industrialisation and development by countries cutting themselves off from international trade and using public expenditure to build infrastructure and to subsidise new industries. The reasons for the failure of import-substitution industrialisation differ from country to country, but from a corporate governance perspective the problems associated with the model were clear. Corporations were not subject to competitive pressures and from a governance point of view the shareholders had little opportunity to exert influence. In many Asian countries, the pursuit of import-substitution industrialisation altered the nature of

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[9] A Sen, *Development as Freedom* (Knopf New York 1999), 3, famously argues that development should be seen 'as a process of expanding the real freedoms that people enjoy'.

[10] A Madison, *The World Economy: A Millennial Perspective* (OECD Washington 2001), Table 1.3, Level and Rate of Growth of GDP: World and Major Regions, 0-1998 A.D.

[11] A Madison, *The World Economy: Historical Statistics* (OECD Paris 2003).

[12] UNDP, *Human Development Report 2007/2008: Fighting Climate Change: Human Solidarity in a Divided World* (New York 2007), 25.

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corporate structures and led to the dominance of large family owned business groups.

The second phase of economic development thinking was the opening of domestic economies to imports, export-led industrialisation and microeconomic reform including privatisation of state-owned industries and reform of financial and labour markets. While the newly industrialising countries of South-East Asia achieved sustained high rates of growth since the 1960s and generated substantial employment, the problems associated with the model from a corporate governance viewpoint became evident during the Asian financial crisis. While dynamic corporations were created during this phase of development, the corporations often operated in repressive political environments with little attention to the promotion of corporate governance.

In the search of new solutions, developmental emphasis turned to weaknesses in developing country governments and institutions,[13] and the new pillar in the third stage of development thinking became institutions.[14] The emphasis on institutions, and in particular legal institutions, intensified after the influential work by a group of economists who conducted cross-country research to determine what legal rules contributed to the development of financial growth.[15] Research into the role of institutions in development is supplemented by research into the role of public governance undertaken primarily by the World Bank Institute.[16] The governance data has been collected since 1996 and reports on six dimensions of governance: 'voice and accountability', 'political stability and absence of violence', 'government effectiveness', 'regulatory quality', 'rule of law' and 'control of corruption'.[17] Corporations continue to be recognised as a significant actor in the current developmental focus on institutions and governance, with emphasis on substantive rules of

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[13] Following the influential work of North (n. 5) and more recently D Rodik, Institutions for High-Quality Growth: What They Are and How to Acquire Them (2000), 35 *Studies in Comparative International Development*, 59; and M Aoki, *Toward a Comparative Institutional Analysis* (MIT Massachusetts 2001).
[14] Dam (n. 6) 5.
[15] R La-Porta, L Lopez-de-Silanes, A Shleifer and R Vishny (LLSV), Law and Finance (1998), 106 *Journal of Political Economy*, 1113.
[16] For example, World Bank Governance and Anti-Corruption, www.worldbank.org/wbi/governance [25 July 2008].
[17] World Bank, Governance Matters 2008: Worldwide Governance Indicators 1996–2008, http://info.worldbank.org/governance/wgi/index.asp [5 July 2008].

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corporate law,[18] corporate social responsibility and the recognition that corporations produce rule-of-law problems.[19]

The present path to economic development with its focus on institutions must pay increased attention to the corporate and financial sector, and the corporate form upon which modern economies are heavily dependent for the conduct of business. This crucial developmental focus must also be on assuring the suppliers of finance of getting a return on their investment, through the better governance of corporations.

1.2.2. *Corporate Governance and Economic Development*

The existing literature on the nexus between corporate governance and economic development suggests that there is an emerging consensus on the importance of corporate governance for economic growth and development. The focus of the studies reviewed is primarily on firm-level and country-level corporate governance measures and law-on-the books. Notably, some studies extend their analysis to the effects of ownership and control on firm valuation, operational performance and the risk of financial crises. While efforts by scholars, to capture the effects of ownership and control structures of corporations, on the governance of such corporations and in turn, on economic development is to be appreciated, gaps can also be identified where further work exploring the nexus between corporate ownership and control, corporate governance and economic development can be undertaken.

The literature reviewed below demonstrates the emerging acceptance of corporate governance as a crucial factor in economic development, primarily since it relates directly to the establishment of long-term productivity and sustained growth. Thus, the argument is that the future of developing countries and financial markets depend on improving governance within and around corporations.

At a microlevel, corporations can promote or impede development through efforts to maximise shareholder value. Corporations can consciously take into account the development impact of corporate activity in making determinations in respect of location, use of technology and also contribute

[18] LLSV (n. 15).
[19] Dam (n. 6), 177.

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to development through non-business activities such as philanthropy and corporate social responsibility.[20] Effective corporate governance is also proclaimed as having the ability to impact upon development at a macrolevel by enabling access to finance. Global and local flows of capital should lower the cost of capital, resulting in better corporate performance and higher corporate valuation. This in turn should result in favourable treatment of all stakeholders,[21] and create financial stability and stimulate economic growth and development.

The literature identifies several channels through which corporate governance impacts upon economic development, specifically, through the development of the financial sector and increased access to financing, improved firm valuation, better operational performance and the reduction of the risk of financial crises.[22]

(a) *Development of the Financial Sector and Increased Access to Financing*

In making the argument that corporate governance impacts upon the development of the financial sector and increased access to financing, it must be set out at the outset that economists sharply disagree about the role of financial markets in promoting growth.[23]

Yet the idea that financial markets contribute to economic growth and in turn development seems an obvious proposition and is supported by numerous studies, which illustrate that effective financial systems ease external financing constraints facing corporations, and highlight that

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[20] D Reed and S Mukherjee (eds.), *Corporate Governance, Economic Reforms and Development: The Indian Experience* (Oxford University Press New Delhi 2004), 30.

[21] S Claessens, *Focus 1: Corporate Governance and Development* (Global Corporate Governance Forum-World Bank Washington DC 2003), 1.

[22] International Finance Corporation, *A Corporate Governance Approach Statement by Development Finance Institutions* (Washington DC 2007), lists improving performance, access to capital, improving stakeholder relations, developing capital markets, reducing investment risk and adding value and avoiding reputational risk as reasons why corporate governance matters in emerging markets.

[23] J Robinson, *The Rate of Interest and Other Essays* (Macmillan London 1952); and R Lucas, On the Mechanics of Economic Development (1988), 22 *Journal of Monetary Economics*, 3, argue that financial systems merely respond to economic development adjusting to demands from the real sector.

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financial development influences economic growth.[24] Extensive studies have also established that banking and stock market development are good predictors of economic growth.[25]

The law and finance literature shows a positive correlation between shareholder and creditor rights, and banking and capital markets. La Porta *et al*.,[26] find that better creditor rights[27] are rewarded with greater depth of the financial system.[28] Similarly, they find that the better the quality of the shareholder protection,[29] the larger the size of the country's stock market. While other macroeconomic factors and inflation may affect the depth of a financial system, it is undoubted that better quality of shareholder protection and better creditor rights, in other words, a better-governed corporate sector affects the size of a country's financial market and affords greater access to financing. This fact is also supported by the property rights literature which find that in countries with better property rights, corporations have better access to finance and can be expected to contribute to financial development.[30]

Similarly, the argument is made that poor corporate governance (both firm level and country level) stands in the way of countries getting the full benefit of globalisation. Poor governance causes corporations to be valued less by capital markets which inhibits

[24] R King and R Levine, Finance and Growth: Schumpeter Might be Right (1993), 108 *Quarterly Journal of Economics*, 717, illustrate that countries with larger initial capital markets grow faster in the future; T Beck, R Levine and N Loayza, Finance and Sources of Growth (2000), 58 *Journal of Financial Economics*, 261; W Carlin and C Mayer, Finance, Investment and Growth (2003), 69 *Journal of Financial Economics*, 191; R Levine, Finance and Growth: Theory, Evidence and Mechanisms, in P Aghion and S Durlauf (eds.), *Handbook of Economic Growth* (North-Holland Elsevier Publishers Amsterdam 2004).

[25] T Beck, A Demirguc-Kunt and R Levine, Law and Firms' Access to Finance (2004), World Bank Policy Research Working Paper 3194, http://ssrn.com/abstract=570365 [10 February 2005]; A Demirguc-Kunt, Finance and Economic Development: Policy Choices for Developing Countries (2006), World Bank Policy Research Working Paper 3955, http://ssrn.com/abstract=923262 [20 July 2008].

[26] LLSV, Legal Determinants of External Finance (1997), 52 *Journal of Finance*, 1131.

[27] Adjusted for the extent to which the rule of law is being enforced in the country.

[28] As measured by the ratio of private credit to GDP.

[29] Adjusted for the efficiency of the judicial system.

[30] S Claessens and L Laeven, Financial Development, Property Rights, and Growth (2002), 58 *Journal of Finance*, 2401.

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the ability of entrepreneurs to finance their activities and impedes growth.[31]

There is also evidence that poor corporate governance and underdeveloped financial markets adversely affects growth and development. In a firm-level survey covering 54 countries, Beck *et al.*[32] find that underdeveloped financial and legal systems, and higher corruption affect the growth rates of the smallest companies within their sample. Similarly, Levine and Zervos[33] find that lower stock market development can reduce growth.

(b) *Cost of Capital and Firm Valuation*

Corporate governance is also recognised as affecting access to finance and the development of financial markets by its effect on firm valuation. Higher firm value makes investments attractive to investors and has the ability of lowering the cost of capital and leading to growth and economic development. In contrast, in poor corporate governance environments, external finance is likely to be constrained and costly by the fact that financiers are less willing to provide financing because the environment does not assure them of adequate protection of their investment. Those that do provide financing are likely to charge higher rates and impose conditions or engage in expropriation, driving up the cost of capital.

A well-known line of research that begins with a series of papers by La Porta *et al.*,[34] provide evidence that countries with stronger legal protections of minority shareholders have larger securities markets, less concentrated share ownership and a higher value for minority shares.[35]

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[31] R Stultz, Corporate Governance and Financial Globalization, National Bureau of Economic Research Reporter (Fall 2005), 13.

[32] T Beck, A Demirguc-Kunt and R Levine (n. 25).

[33] R Levine and S Zervos, Stock Markets, Banks, and Economic Growth (1998), 88 *American Economic Review*, 537.

[34] LLSV (n. 26); LLSV (n. 15); LLSV, Investor Protection and Corporate Governance (2000), 58 *Journal of Financial Economics*, 3; LLSV, Agency Problems and Dividend Policies Around the World (2000), 55 *Journal of Finance*, 1.

[35] LLSV, Agency Problems and Dividend Policies Around the World (2000), 55 *Journal of Finance*, 1, additionally illustrates that better minority shareholder protection is associated with higher dividend payouts in a cross section of firms from around the world.

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The La Porta *et al*. study has been expanded with country-specific research illustrating that investors are willing to pay a significant premium for well-governed firms.[36] In comparing the findings of these country-specific studies it is worth noting that the relationship between corporate governance and firm value seems stronger in countries with less developed governance standards. More recent studies have found that better governance is related to higher firm valuation as proxied by Tobin's Q,[37] and that both internal and external governance factors are related to firm value.[38]

The McKinsey Global Investor Opinion Survey on Corporate Governance 2002 illustrates that 15 percent of Western European, 21 percent of Asian and 40 percent of Eastern European and African institutional investors consider corporate governance as more important than a firm's financial issues such as profit, performance or growth potential.[39] Additionally, an overwhelming majority of investors are prepared to pay a premium for companies exhibiting high governance standards, with premiums averaging 12–14 percent in North America and Western Europe, 20–25 percent in Asia and Latin America and over 30 percent in Eastern Europe and Africa.

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[36] While the correlation between governance attributes and a firm's value in developed markets show weak or no results (for example, S Bhagat and B Black, The Uncertain Relationship between Board Composition and Firm Performance (1999), 55 *Business Lawyer*, 921); it is significantly different in emerging markets, for example, B Black, Does Corporate Governance Matter? A Crude Test Using Russian Data (2001), 149 *University of Pennsylvania Law Review*, 2131; C Bai *et al*., Corporate Governance and Market Valuation in China (2003), William Davidson Institute Working Paper 564, http://ssrn.com/abstract=393440 [20 July 2008]; W Kim, B Black and H Jang, Does Corporate Governance Predict Firms' Market Values? Evidence from Korea (2006), 22 *Journal of Law, Economics, and Organization*, 366.

[37] L Bebchuck, A Cohen and A Ferrell, What Matters in Corporate Governance? (2005), Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper 491; L Bebchuk and A Cohen, The Costs of Entrenched Boards (2005), 78 *Journal of Financial Economics*, 409. Tobin's Q as a measure of performance is calculated by dividing the market value of a company by the replacement value of its assets. Alternatively, return on assets (ROA) may also be used to measure firm valuation.

[38] L Brown and M Caylor, Corporate Governance and Firm Valuation (2006), 25 *Journal of Accounting and Public Policy*, 409.

[39] McKinsey and Company, McKinsey Global Investor Opinion Survey on Corporate Governance 2002: Key Findings, http://www.mckinsey.com/clientservice/organization leadership/service/corpgovernance/pdf/globalinvestoropinionsurvey2002.pdf [5 July 2008].

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The correlation between corporate governance and firm valuation is also supported by studies demonstrating that in countries with weaker corporate governance mechanisms,[40] controlling shareholders are able to obtain higher private benefits of control.[41] The benefits obtained by such controlling shareholders exceed their direct ownership stake and is at the expense of minority shareholders. This results in lower firm valuation and higher cost of capital,[42] inhibiting access to finance and growth.

(c) *Improved Operational Performance*

Corporate governance also has the ability to stimulate development by better operational performance through better allocation of resources, efficiency and better management.

Although the evidence is less strong of higher operational performance in countries with better corporate governance, there is evidence to strongly suggest that at firm level, better corporate governance leads not only to improved rates of return on equity and higher valuation, but also to higher profits, sales growth and lower capital expenditures.[43] Klapper and Love[44]using firm-level data from 14 emerging stock markets report that better firm-level corporate governance is highly correlated with better operating performance and higher market valuation.

Claessens,[45] plotting the accounting rates of assets for a sample of publicly listed firms using data from the Worldscope database against an

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[40] The variables extend to legal origin, rule of law, accounting standards, competition laws, antidirector index, serious crime, labour protection measures etc.

[41] A Dyck and L Zingales, Private Benefits of Control: An International Comparison (2004), 59 *Journal of Finance*, 537.

[42] The economic costs of poor corporate governance due to controlling shareholders and family ownership is illustrated by R Morck, D Wolfenzon and B Yeung, Corporate Governance, Economic Entrenchment and Growth (2004), National Bureau of Economic Research Working Paper 10692, http://papers.nber.org/papers/w10692.pdf [5 November 2005].

[43] P Gompers, L Ishii and A Metrick, Corporate Governance and Equity Prices (2003), 118 *Quarterly Journal of Economics*, 107, use takeover defenses in the 1990s to create a corporate governance index in respect to US companies in the 1990s; also, L Bebchuck, A Cohen and A Ferrell (n. 37).

[44] LF Klapper and I Love, Corporate Governance, Investor Protection, and Performance, in Emerging Markets (2002), World Bank Policy Research Working Paper 2818.

[45] S Claessens (n. 21), Fig. 6.

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equity rights index from R La-Porta, L Lopez-de-Silanes, A Shleifer and R Vishny ('LLSV'),[46] finds a less strong relationship between the measure of the quality of the governance framework and firm performance. This is attributed to other factors affecting operational performance, namely, the possibility for reporting bias in worse corporate governance environments which makes it likely that their accounting profits are overstated or that firms in developing countries may face better growth opportunities and therefore, have higher profits.

Claessens also notes that the limited relationship between operational performance and corporate governance measures at country level may reflect the fact that corporate governance in most countries does not concern a conflict between the management and owners leading to poor operating performance.[47] This is supported by the hypothesis that concentrated ownership by providing better monitoring incentives should lead to improved firm performance, although the extraction of private benefits of control by controlling shareholders at the expense of the minority shareholders should lead to lower firm valuation and reduced access to financing. However, empirical studies for both the United States and the United Kingdom suggest that at low levels of ownership concentration, firm performance increases as concentration increases, but then declines as concentration levels keep increasing,[48] and therefore, concentrated ownership may not always result in improved firm performance. It is also important to note that within concentrated ownership structures different owners (parent companies, families, large shareholders) will have different objectives, and it is likely that the identity of the owner will matter for firm performance. Furthermore, performance is also likely to be affected by the industry in question, the stage in the life-cycle of the firm and product market competition.[49]

Recent studies also attempt to identify the exact corporate governance mechanisms most related to improved operating performance. Brown and Caylor using a summary governance score (Gov-Score) based on an Institutional Shareholder Services dataset which is a composite measure

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[46] LLSV (n. 15).

[47] S Claessens (n. 21), 18.

[48] R Morck, A Shleifer and R Vishny, Management Ownership and Market Valuation: An Empirical Analysis (1988), 20 *Journal of Financial Economics*, 293, as measured by Tobin's Q.

[49] M Maher and T Anderson, Corporate Governance: Effects on Firm Performance and Economic Growth (1999), http://www.ecgi.de/research/accession/cgeu.pdf [20 July 2008].

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of 51 factors encompassing eight corporate governance categories, find that good governance, as measured using executive and director compensation is highly associated with good firm performance.[50] Bhagat and Bolton find that while stock ownership of board members and Chief Executive Officer (CEO) chairperson separation is positively correlated with better contemporaneous and subsequent operating performance, board independence is negatively correlated with contemporaneous and subsequent operating performance.[51]

While future research is needed to identify with clarity the governance mechanisms most likely to bring about improved operational firm performance taking into account country-specific variables, and firm-level corporate governance, for purposes of this study, the existing positive correlation between firm-level corporate governance and improved firm performance does illustrate the ability of corporate governance to improve the allocation of resources, create wealth and contribute to growth and development within countries.

(d) *Reduced Risk of Financial Crises*

The quality of corporate governance of individual firms can have economy-wide effects and may actually contribute to the occurrence or the heightening of financial distress. Poor corporate governance permits the expropriation of minority shareholders especially during times of financial distress. Similarly, the disclosure regime is likely to be weak in developing economies and can result in the withholding of bad information or the release of selective information. Further, cross-holdings and pyramid structures within poor governance systems are also likely to cause and increase risk sharing among corporate groups, thereby increasing the chances of conglomerate-level failures.

Evidence of the ability of firm-level governance to minimise the effects of financial distress is illustrated by a study of firms from Indonesia, Korea, Malaysia, Philippines and Thailand, which finds that firm-level differences in variables related to corporate governance, in particular firms

[50] L Brown and M Caylor, Corporate Governance and Firm Performance (2004), http://ssrn.com/abstract=586423 [21 July 2008].
[51] S Bhagat and B Bolton, Corporate Governance and Firm Performance (2007), http://w4.stern.nyu.edu/emplibrary/Bhagat_paper_revised.pdf [21 July 2008].

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with higher accounting disclosure and higher outside ownership, had better performance during the East Asian financial crisis of 1997–1998.[52]

Country-level evidence that countries with weak corporate governance suffer larger collapses when hit by adverse shocks is presented by Johnson *et al*.,[53] who find that the weakness of legal institutions for corporate governance, particularly the effectiveness of minority protection had an adverse effect on the extent of exchange rate depreciations and stock market declines in the Asian financial crisis. This is primarily due to the fact that in countries with weak investor protection, negative financial events are more likely to adversely affect investor confidence resulting in collapses in currency and stock prices. Country studies by international financial institutions also support the view that poor corporate governance was one of the major contributors to the build up of vulnerabilities in the affected countries that led to the Asian financial crisis.[54] The findings suggest that the weaknesses in corporate governance in the affected countries can be attributed to concentrated ownership structures, government intervention, underdeveloped capital markets and poor investor protection.[55]

The thinking until the present financial crisis was that failures or weakness in corporate governance would not result in a financial crisis in the developed world due to stronger institutional foundations, the size of the financial markets or the fact that weak governance mechanisms were often limited to one or two specific areas of governance, such as audit fraud or inflated reports of stock performance. The present financial crisis has dispelled such myth. Weak corporate governance mechanisms have led to a loss of confidence in the developed world, a slow down in economic growth, and contributed to the current financial

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[52] T Mitton, A Cross-firm Analysis of the Impact of Corporate Governance on the East Asian Financial Crisis (2002), 64 *Journal of Financial Economics*, 215.
[53] S Johnson *et al.*, Corporate Governance in the Asian Financial Crisis (2000), 58 *Journal of Financial Economics*, 141.
[54] V Capulong, D Edwards and J Zhuang (eds.), *Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand: Volume Two* (*Country Studies*) (Asian Development Bank Manila 2001).
[55] ibid.
[56] G Kirkpatrick, *Corporate Governance Lessons from the Financial Crisis* (OECD Paris 2009), analyses the failures and weaknesses in corporate governance on the financial crisis, including risk management systems and executive salaries and concludes that the financial crisis can to a certain extent be attributed to the weaknesses and failures of corporate governance arrangements which did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies.

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crisis.[56] While it is accepted that macroeconomic causes exist for the current financial crisis,[57] and further evidence and measurement is required with respect to the impact, failures and weaknesses of corporate governance have on corporate collapses within developed financial markets, it is undoubted that deficiencies in corporate governance in the developed world contributed to the loss of investor confidence within particular firms and industries. The linkage of deficiencies in corporate governance in the developed world to the present financial crisis supports the thinking that corporate governance strengthens the overall international financial system and reduces the vulnerability of both developed and emerging markets to financial crises.

1.2.3. *The Emerging Consensus*

The review of the existing literature on corporate governance and economic development illustrates the emerging consensus and positive correlation between corporate governance and economic growth and development, due to the ability of effective corporate governance to facilitate increased access to external financing by firms, lower costs of capital, increase firm valuation, achieve better operational performance by better management and resource allocation, and minimise the risk of financial crises.

Despite clear evidence of the importance of corporate governance to growth in the long run, and economic development, corporate governance continues to be perceived as being of little importance to economic development. The first reason attributed for this misperception is the belief that corporate governance serves to protect the interests of a shareholding class from the misbehaviours of corporate managers and does not therefore affect the lives of the vast majority of the population. This is flawed reasoning. First, the ultimate owners of large companies, not only in the developed countries but also in developing countries[58] (although to a lesser extent) are not the wealthy and the privileged. They are the majority of the population whose pension entitlements are directly linked to investments in the shares of large- and mid-sized companies.[59] Second, financial

[57] International Organisation of Securities Commissions, *Report on the Subprime Crisis* (*Final Report*) (Madrid 2008).
[58] Often by way of state pension funds and investments by commercial and savings banks in stock markets.
[59] D Pitt-Watson, Why Corporate Governance Is Important (2003), 14 *The Edge*, 29.

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crises have revealed that shortcomings in corporate governance are not limited to companies and their shareholders. In fact, the repercussions are economy wide.[60] Third, the literature reviewed above,[61] emphatically demonstrates the crucial link between growth, economic development and corporate governance, and effectively rebuts the argument that corporate governance only serves to protect the interests of shareholders of large companies.

The second argument lending support to the view that corporate governance is of little importance for economic development, is based on the challenging question of the high levels of growth achieved by countries in continental Europe during the post-world war period and in Asia in the 1990s while seemingly characterised by poor corporate governance. Krugman[62] asserts that the remarkable period of high growth in output in Asia from the 1960s to the 1990s may have derived more from a mobilisation of the factors of production (i.e., inputs like labour and capital) within the region rather than from productivity growth or efficiency gains. The mobilisation of the factors of production, it may be argued, is less incompatible with strong institutions of corporate governance. Similarly, Miesel[63] explains France's equally paradoxical growth during 1945–1973 when despite having corporate governance institutions below today's standards the country experienced a period of sustained growth,[64] as attributable to a system of governance which enabled the emergence and prevailing of a 'general interest' particularly among France's elites. In short, France's governance culture (particularly public institutions) enabled growth, despite the prevailing and potentially conflicting private interests. Thus, Miesel argues for change in the way we judge the quality of a country's institutions of governance, for while France's corporate governance institutions may well

[60] One manner in which this manifests itself is by way of higher operational and reputational risk.

[61] In Section 1.2.2.

[62] P Krugman, The Myth of Asia's Miracle (1994), 73 *Foreign Affairs*, 62–71. Similarly, in p. 63 Krugman claims that the Communist growth rates in the 1950s could be fully explained by the rapid growth in inputs, 'expansion of employment, increases in education levels, and, above all, massive investment in physical capita'. The essential point made by Krugman and excellently illustrated in pp. 67–68 is that economic growth that is based on an expansion of inputs, rather than a growth in output per unit of input is subject to diminishing returns.

[63] Meisel (n. 2).

[64] Significantly called the *Trente Glorieuses* — the 'Glorious Thirty'.

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have been below today's standards, it is the society's entire governance culture that affects its long-term development.[65] It could also be argued that while better governance is positively correlated to higher income and growth, the reverse does not always follow.[66]

The evidence surveyed above,[67] clearly demonstrates that effective governance of corporations impacts upon economic development, primarily by creating investor confidence and thereby, directing the flows of investor capital in corporations. This capital in turn, can lead to larger investment, greater growth, the creation of employment and the resultant social and economic development. The increased flows of capital can also stimulate the development of banking systems and financial markets, which are recognised as contributing to growth and development.[68] This in turn, can result in the development of product market competition and the strengthening of the legal institutions increasingly recognised by the academic literature as a major factor in economic development.[69]

The above analysis also reveals that the nexus between corporate governance and economic development is drawn with an initial focus on firm-level and country-level corporate governance measures, particularly law-on-the books. This focus is narrow and does not adequately reflect the governance environment in which corporations exist. Notably some studies extend their analysis to the effects of ownership and control on firm valuation, operational performance and the risk of financial crises. However, further studies on the relationship between the governance culture within a country, the effectiveness of market mechanisms such as

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[65] Miesel (n. 2), 117–121.

[66] D Kaufmann and A Kraay, Growth Without Governance (2002), World Bank Policy Research Working Paper 2928, http://ssrn.com/abstract=316861 [23 April 2009], examine the finding that a strong positive correlation exists between per capita incomes and the quality of governance across countries. They then go on to adopt an empirical strategy that allows separation of this correlation into (1) a strong positive causal effect running from better governance to higher per capita incomes, and, at first, (2) a weak and even negative causal effect running in the opposite direction from per capita incomes to governance. This second finding is surprising and suggests the absence of a vicious cycle with respect to growth and governance, that is, that higher income does not necessarily lead to better governance.

[67] In Section 1.2.2.

[68] A Demirguc-Kunt and R Levine, Stock Markets, Corporate Finance, and Economic Growth: An Overview (1996), 10 *World Bank Economic Review*, 223.

[69] Dam (n. 6), whose thesis is that institutions and the rule of law in particular provide the keys to unlocking the full growth potential of the developing world.

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credit rating agencies and the market for control, the role of politics in business, are necessary to present a holistic picture of the impact of corporate governance on economic development. It is important that the literature extends to external governance mechanisms and country-specific variables such as politics, culture and market structures including corporate ownership and control structures within a jurisdiction, since this would acknowledge the wider contextual framework within which corporations operate and also assist in future efforts at corporate governance reform.

As the wider economic significance of corporate governance becomes increasingly apparent, there has been an explosion of the introduction of codes of best practices for corporations, and the publication of international guidelines[70] advocating good corporate governance. While guidelines and best practices reflect the role good corporate governance can play in promoting economic development, the way ahead may lie not only in promoting firm-level corporate governance, but also in recognising that corporations work within a wider governance framework and that such governance framework is influenced by rules, structures and institutions, those who own and control such corporations, and a country's history and culture.

1.3. Corporate Governance for Economic Development: The Way Forward

The second argument presented in this chapter is that to effectively harness the full potential of the contribution corporate governance makes towards economic development, a more holistic and context-dependent approach must be adopted towards the examination of the relationship between corporate governance and economic development, and also towards future reform. Holistic in the sense that proper account is taken of the environment in which the governance of corporations take place, that is the dynamics of

[70] OECD, *Principles of Corporate Governance: 2004* (Paris 2004); and Commonwealth Association for Corporate Governance, *Corporate Governance Principles 1999* (Marlborough 1999), set out principles of corporate governance primarily for boards of directors of dispersed companies; D Reed Corporate Governance Reforms in Developing Countries (2002), 37 *Journal of Business Ethics*, 223–233 questions, whether the Anglo-American model can generate responsible ownership in developing countries.

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the corporate governance framework, and context dependent in the sense that there is a focus on specific factors within a jurisdiction, such as market structures, institutions, culture and politics, which define the adaptation and effectiveness of corporate governance. While the nexus between corporate governance and economic development is undoubted, how successfully and widely the benefits of value that good corporate governance can add, depends on the corporate governance framework within a jurisdiction.

To support the argument that a more holistic and context-dependent approach must be adopted in examining the relationship between corporate governance and economic development, this study emphasises that corporate governance cannot be viewed as isolated and independent from other legal, market and social institutions and market structures, but rather that the success of corporate governance is contingent upon a number of different factors within the corporate governance framework. For this purpose, the definition of corporate governance is critically examined and thereafter, a corporate governance framework adopted from within which corporate governance can be analysed and its success promoted to achieve the goal of economic development.

1.3.1. *Corporate Governance*

Although the term corporate governance is relatively new,[71] questions surrounding the governance of firms have been in existence for much longer. Traditionally, corporate governance as its name implies, is about how to properly govern a firm. Originating from the Greek word '*kubernan*' which means 'to steer',[72] governance is, about the power to control, regulate and decide. The most evocative definition is that 'corporate governance deals with ways in which suppliers of finance to corporations assure themselves of getting a return on their investment',[73] which implicitly recognises corporate governance as being concerned with the

[71] J Farrar, *Corporate Governance: Theories, Principles and Practice* (2nd edn Oxford University Press Melbourne 2005), 3, claims the first reference was probably made by Richard Eells of Columbia Business School in *The Government of Corporations* (Free Press New York 1962).

[72] *Concise Oxford English Dictionary* (10th edn rev Oxford University Press Oxford 2002).

[73] A Shleifer and R Vishny, A Survey of Corporate Governance (1997), 52 *Journal of Finance*, 737.

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conflicts of interest among the various corporate stakeholders. In essence, corporate governance refers to the control of companies and mechanisms to make those in control accountable.[74]

In ensuring that the suppliers of finance get a return on their capital, the focus of traditional Anglo-American governance literature is predominantly on internal governance structures such as shareholders, the board, the management team and their relationships *inter se*. This focus is narrow, ignoring the external environment in which corporations exist. Corporate governance mechanisms include not only legal and formal mechanisms such as the board of directors and management, but also external governance mechanisms such as markets, institutions, legal and regulatory frameworks that influence corporate governance.[75] A broader approach is to define a governance system as 'the complex set of constraints that shape the *ex post* bargaining over the quasi-rents generated by the firm'.[76] This is a more abstract model, in which rules and law play a critical role, but also takes into consideration external constraints imposed by equity and debt markets, institutions and market structures such as corporate ownership and control structures.

1.3.2. *Systems and Practices*

An important distinction made in this study is that, corporate governance 'practices' such as determination of the powers of the board of directors and protection of minority investors, cannot be reformed in isolation without regard to the 'system' of corporate governance, which reflects a country's economic, social and political forces. While macroeconomic policies, structures and social issues are not strictly regarded as part of

[74] The Committee on the Financial Aspects of Corporate Governance, *The Financial Aspects of Corporate Governance* (London 1992) para 2.5, 'the system by which companies are directed and controlled'.
[75] J Gordon, The Shaping Force of Corporate Law in the New Economic Order (1997), 31 *University of Richmond Law Review,* 1473–1474, defines corporate governance as the 'mechanisms by which various marketplace signals, particularly from product markets and capital markets, directly influence the makeup of the management team that makes economic decisions for the firm, and in that way, indirectly influence the economic decisions themselves'.
[76] L Zingales, Corporate Governance in P Newman (ed.), *The New Palgrave Dictionary of Economics and the Law* (Macmillan New York 1998), 499.

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corporate governance in its traditional sense, they impact on the effectiveness of corporate governance practices.

For this purpose, the following distinction between a 'system' of corporate governance and corporate governance 'practices' is adopted:

> A *system* of corporate governance consists of those formal and informal institutions, laws, values and rules that generate the menu of legal and organisational forms available in a country and which in turn determine the distribution of power — how ownership is assigned, managerial decisions are made and monitored, information is audited and released and profits and benefits allocated and distributed (emphasis added).[77]

> Corporate governance *practices* are those rules that apply to specific financial markets and organisational forms, and that establish the discretion of parties that possess control rights and the information and mechanisms at their disposal to choose management, propose or confirm major strategic decisions, and to determine the distribution of remuneration and profit (emphasis added).[78]

As the definition indicates, a 'system' reflects political and social forces with economic repercussions within a country. As the study later illustrates, systems lie at the heart of divergence in corporate governance. Further, the complementary nature between a 'system' of corporate governance and corporate governance 'practices' must be appreciated to identify and define corporate governance issues. While best practices, are aimed at improving corporate governance regardless of the system, the identification of the system of corporate governance enables practices to be 'best fit'. For example, recognition that controlling shareholder systems with board domination by a controlling shareholder is likely to require more than mere improvement to board practices.

1.3.3. *Systems of Corporate Governance*

'Systems' of corporate governance reflect a country's market structures, political and legal institutions, social forces and financial system

[77] P Cornelius and B Kogut, Introduction, in P Cornelius and B Kogut (eds.), *Corporate Governance and Capital Flows in a Global Economy* (Oxford University Press New York 2003), 2.
[78] ibid 3.

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and are often categorised according to the ownership structures of companies.

Systems of corporate governance rose to prominence in the midst of the American Great Depression, when an economics and a law professor Adolf Berle and Gardiner Means, respectively at Columbia University, analysing the vast dispersion of share ownership in the United States in the late 1920s, identified that shareholders in large listed companies were so dispersed that they had little control over the management of the corporation.[79] This, they claimed was due to the separation between ownership of the corporation — vested in the hands of dispersed shareholders, and control of the corporation — being vested in the hands of directors and managers. This separation of ownership and control, according to Berle and Means could result in the directors and managers acting in their own interests to the detriment of the dispersed shareholders. The Berle and Means analysis by its force of logic and simplicity, gave rise to corporate law's continued preoccupation with negating the costs arising from the separation of ownership and control.

The Berle and Means analysis that dispersed ownership led to a separation of ownership and control had no application to many nations, because corporate ownership was concentrated in the hands of a few shareholders. This distinction in ownership structures influenced by local market structures, political and legal institutions and social forces contributed to the rise of rival systems of corporate governance.

(a) *Outsider/Arm's Length System* (*Dispersed Ownership*)

The 'outsider/arm's length'[80] system of corporate governance is based on the Berle and Means finding that large public corporations in the United States are characterised by the separation of ownership and control. The term 'outsider' is used to describe the situation that exists because share ownership is dispersed among a number of investors, while the term 'arm's

[79] A Berle and G Means, *The Modern Corporation and Private Property* (Rev edn Harcourt, Brace & World Inc New York 1967), 7, 'quasi public corporation … has divided ownership into nominal ownership and the power formerly joined to it'.
[80] Term used by E Berglöf, A Note on the Typology of Financial Systems, in K Hopt and E Wymeersch (eds.), *Comparative Corporate Governance: Essays and Materials* (Walter de Gruyter & Co Berlin 1997), 151–164.

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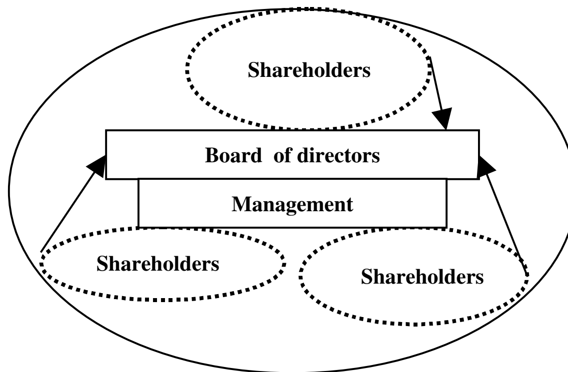

Figure 1.1: Outsider/Arm's Length System.

length' indicates that shareholders tend to distance themselves from the running of the business and therefore, tend to give managers a free hand to manage the corporation.[81] The 'outsider/arm's length' system is typically characterised by long-term financing through capital markets and therefore, sometimes referred to as the 'market-oriented' system (Fig. 1.1).

(b) *Insider/Control-Oriented System* (*Concentrated Ownership*)

Recent corporate governance scholarship produced startling revelations. Empirical evidence demonstrates that while the 'outsider/arm's length' system, the basis of the Berle and Means analysis is largely true of the system of corporate governance in the United Kingdom and United States where most large companies are publicly quoted and share ownership dispersed, it is uncommon in a large part of the world. Further, studies even within the United States demonstrate modest concentration of ownership for large American firms.[82] Studies of several wealthy countries also

[81] ibid.

[82] M Eisenberg, *The Structure of the Corporation: A Legal Analysis* (Little Brown & Co., Boston 1976); A Shleifer and R Vishny, Large Shareholders and Corporate Control (1986), 94 *Journal of Political Economy*, 461–462. Under the Influence, *Economist* (London 17 November 2001), 57, estimates that founding families influence between 35 and 45 percent of America's 500 largest listed companies depending on how 'influence' is defined.

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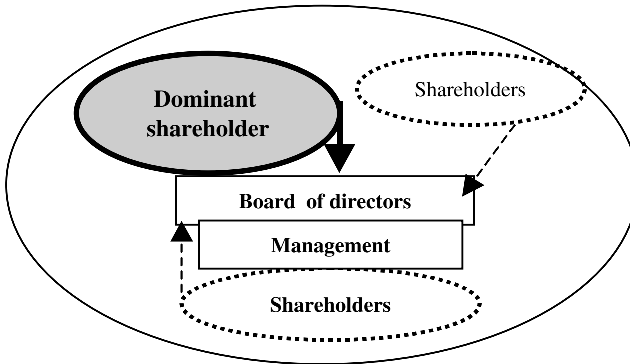

Figure 1.2: Insider/Control-Oriented System.

demonstrate a significant concentration of ownership.[83] It is also established that ownership is heavily concentrated in developing economies.[84]

Heavy concentration of ownership led to the recognition of an alternative system of corporate governance termed 'insider/control-oriented', where core shareholders exert considerable influence over management decisions (Fig. 1.2). In continental Europe and in large parts of the world, many large businesses have a majority shareholder or core investors owning a substantial portion of the equity. The prevalence of cross-shareholdings also ensures that, corporate control is retained by core investors or by the founding family. The importance of networking between core shareholders explains why this system is sometimes referred to as a 'network-oriented' system.[85]

(c) *The Models*

The 'systems' of corporate governance reflecting a country's market and institutional structures give rise to distinct 'models' of corporate governance in accordance with the nature of the agency conflict that arises

[83] European Corporate Governance Network, *The Separation of Ownership and Control: A Survey of 7 European Countries: Preliminary Report to the European Commission* Volumes 1–4 (Brussels 1997); R La-Porta, F Lopez-de-Silanes and A Shleifer, Corporate Ownership Around the World (1999), 54 *Journal of Finance*, 471.

[84] LLSV (n. 15), 1146–1148, Table 7, provides evidence of large shareholders in 47 countries, exploring the hypothesis that countries with poor investor protection have higher concentration of ownership.

[85] L Van den Berghe *et al.*, *Corporate Governance in a Globalising World: Convergence or Divergence? A European Perspective* (Kluwer Boston 2000), 11.

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within such system. These models are characterised by the importance they accord to different constituents within the company, due to the system of corporate governance identifying that the costs associated in managing the company under such system, can best be negated by the adoption of a particular model. For example, the 'outsider/arm's length' system views the 'principal-agent' problem of making corporate managers loyal 'agents' for shareholders,[86] as the central problem of corporate governance. The model is primarily concerned with techniques by which the interests of management can be aligned with those of the shareholders, while at the same time minimising the associated costs arising as a result of dispersed ownership structures. This led to the acceptance of the 'shareholder primacy norm'[87] and the resultant 'shareholder-oriented' model becoming a determinant in corporate law and governance evolution during the 20th century.

The alternative corporate governance models discussed in the literature, are the 'manager-oriented' model based on granting discretion to professional managers, the 'state-oriented' model in which the state is proactive in companies especially in welfare states, the 'labour-oriented' model whereby employees have greater participation in the management,[88] or the 'stakeholder' model whereby the interests of constituents such as the environment, workers and community are considered. These models have not worked in isolation. Often arguments are advanced on a mix and match approach.[89]

The prevalence of concentrated ownership systems gives rise to the model of 'owner-managed firms'[90] where the central issue is achieving

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[86] M Jensen and W Meckling, The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure (1976), 3 *Journal of Financial Economics*, 305; E Fama and M Jensen, Separation of Ownership and Control (1983), 26 *Journal of Law and Economics*, 301.

[87] Enhancing shareholder value. For a recent explanation, see M Blair, Shareholder Value, Cor-porate Governance, and Corporate Performance: A Post-Enron Reassessment of the Conventional Wisdom, in P Cornelius and B Kogut (eds.), *Corporate Governance and Capital Flows in a Global Economy* (Oxford University Press New York 2003), Chapter 3.

[88] The *Mitbestimmung* law in Germany requiring worker participation in the supervisory boards of large companies.

[89] L Van den Berghe, Redefining the Role and Content of Corporate Governance from the Perspective of Business in Society and Corporate Social Responsibility, in P Cornelius and B Kogut (eds.), *Corporate Governance and Capital Flows in a Global Economy* (Oxford University Press New York 2003), 481–486, argues that 'corporate governance should aim at optimising the (long-term) return to shareholders while satisfying the legitimate expectations of stakeholders'.

[90] E Berglöf and A Pajuste, Emerging Owners, Eclipsing Markets? Corporate Governance in Central and Eastern Markets, in PK Cornelius and B Kogut (eds.), *Corporate Governance and Capital Flows in a Global Economy* (Oxford University Press New York 2003), 267.

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a balance between providing incentives to entrepreneurs and protecting minority shareholders.[91] First, there are costs in ensuring that block holders do not expropriate to the detriment of minority shareholders.[92] Second, as large block holders increasingly engage professional managers there are costs involved in monitoring professional managers, similar to the agency problem in dispersed ownership, with the distinction that incentives for providing such monitoring rests with block holders.

1.3.4. *Corporate Governance Framework*

To appreciate the definitional scope of corporate governance, recognise the interaction between the different components of corporate governance and understand the argument presented in this study, that corporate governance cannot be viewed as an isolated phenomenon divorced from other legal, market and social factors within a country, this chapter adopts with modification the 'hierarchical corporate governance framework' proposed by Van den Berghe *et al.* (Fig. 1.3).[93]

First, the above framework illustrates that at its simplest, corporate governance focuses on the operation and composition of the board of directors. In a broader context, corporate governance is viewed as

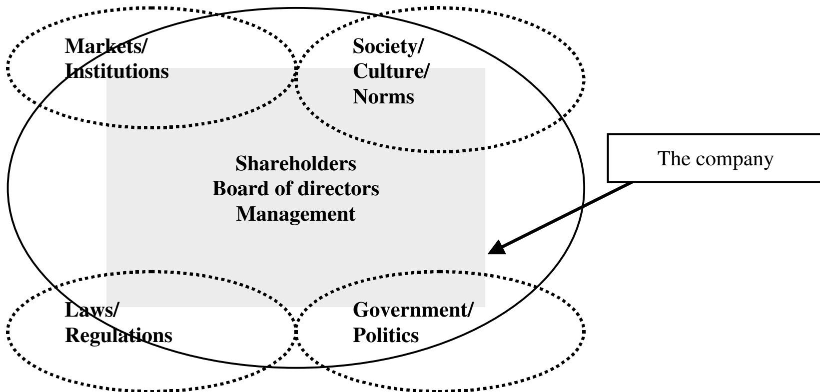

Figure 1.3: Corporate Governance Framework.

[91] ibid.

[92] Shleifer and Vishny (n. 73), 758–760.

[93] Van den Berghe *et al.* (n. 85).

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governing the relationships between shareholders, directors and management. In a more holistic approach,[94] the corporate governance framework takes into consideration macroissues such as corporate culture, values of entrepreneurs, the role of government in economic activities, financing through capital markets and competition. The framework will differ from country to country, since it reflects history and culture while also embodying rules and institutions. The framework is also likely to change and develop over time, although the direction of such change is hard to predict.

Second, the framework supports the argument that corporate governance is not an isolated phenomenon but that the success of corporate governance is contingent upon legal, regulatory, political and social institutions and market structures. This in turn lends support to the argument presented in this chapter that a holistic and context-dependent approach is necessary to understand the relationship between corporate governance and economic development. It also supports the view that the appropriate corporate governance model for facilitating economic development must take into account the distinct factors within the contextual and holistic corporate governance framework.

Third, the framework implicitly recognises and illustrates that corporations are shaped by market structures around them,[95] both local and global. The 'system'[96] of corporate governance that emerges from within such framework, gives rise to divergent 'models'[97] of corporate governance due to the distinctive nature of the agency conflict that arises within each system, essentially tying the agency conflict to market structures (corporate ownership and control structures in particular) and both supporting and motivating the primary thesis of this study that an analysis into corporate governance reform must begin with a focus on local market structures that define the adaptation and effectiveness of corporate governance. To illustrate, the lack of finance, poor law enforcement and nepotism within many developing countries often results in an insider/control-oriented system, characterised by concentrated ownership structures and an 'owner-managed'

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[94] Fig. 1.3.

[95] L Bebchuck and M Roe, A Theory of Path Dependence in Corporate Ownership and Governance (1999), 52 *Stanford Law Review*, 127, argue that corporate structures within an economy are path dependent, that is, likely to depend on initial ownership structures ('structure driven') and corporate rules, which are shaped by ownership structures ('rule driven'), which the economy had at an earlier time.

[96] Section 1.3.3.

[97] Section 1.3.3 (c).

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model where the primary agency conflict is between controlling and minority shareholders. A process of corporate governance reform that fails to evaluate the corporate governance framework of market structures and institutions is likely to overlook subtle nuances within the framework such as poor law enforcement. The resulting ill-suited corporate governance reforms, such as a single focus on improving law-on-the-books to meet the agency conflict between controlling and minority shareholders is unlikely to be effective in an environment of poor enforcement and demonstrates why it would be wrong to ignore the contextual and holistic corporate governance framework, which requires attention to market structures and the external governance environment.

Fourth, taking the analysis further, the framework highlights the importance of corporate ownership and control structures as a starting point within the corporate governance framework and also illustrates the nature of the relationship between corporate ownership, control and corporate governance with specific reference to the agency conflict.[98]

1.4. Conclusion

Corporate governance was, until the Asian financial crisis, perceived as important mainly for companies whose shares trade on the stock market. In developing countries the preponderance of small companies, which are not traded on the stock market coupled with family owned, state-owned or foreign-owned companies whose shares are not traded locally, and the ability of some countries to achieve growth without effective corporate governance, illustrate why many doubt the significance of corporate governance for economic development. Yet, corporate governance is not limited to large public-owned companies or companies whose shares are traded on stock markets. Nor is it possible to achieve long-term and sustainable economic development without effective corporate governance. This chapter seeks to dispel such myths by its analysis of the relationship between corporate governance and economic development, and by its argument for a holistic and contextual approach to understanding the relationship between corporate governance and economic development.

This chapter illustrates and analyses the nexus between economic development and corporate governance in two ways. First, by a rigorous

[98] This argument is further developed in Chapter 2.

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review of the literature on corporate governance and economic development. Second, by presenting and supporting the argument that if corporate governance is to support economic development, it should be approached in a holistic and context-dependent manner.

The important question then is, how does the investigation of the nexus between corporate governance and economic development assist future corporate governance policy? This chapter demonstrates that two points are of value to future policy makers and reformers. First, the general importance of corporate governance to economic development is established, albeit mostly at firm and country level. Second, that corporate governance should be viewed in the context of its internal and external governance framework, taking account of the factors within a country with the ability to affect the proper governance of its corporations. This should enable reform agendas to move away from an exclusive focus on law-on-the-books or institutional development to a more inclusive approach taking into account the environment in which corporations exist.

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