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Corporate Governance: A Development Challenge

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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. Is corporate governance as 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 non-corporate forms of enterprise often account for a significant proportion of local employment and output? At least 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. Yet 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 flag.

Those efforts need rather to be strengthened. OECD Development Centre research on the importance of local corporate governance for sustained productivity growth in the developing world, and the Regional Corporate Governance Roundtables organised by the OECD Corporate Affairs Division 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.

Why Corporate Governance Matters for Development

A country's system of corporate governance comprises the formal and informal rules, accepted practices and enforcement mechanisms, private and public, which together govern the relationships between people who effectively control corporations ("corporate insiders"), on one hand, and all others who may invest resources in corporations located in the country, on the other. Well-governed companies with actively traded shares, it is widely thought (and the evidence suggests), should be able to raise funds from non-controlling investors at significantly lower cost than poorly governed companies, because of the greater risk-premium such potential investors can be expected to demand for investing – if they accept to invest at all – 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 paucity there of firms with widely traded shares.

Yet the poor quality of local systems of corporate governance lies at the heart of one of the greatest challenges most countries in the developing world currently

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face: how successfully (often in the face of much covert or overt resistance from powerful locally entrenched interest groups) to transform local systems of economic and political governance – including those of corporate governance – from systems that tend to be highly personalised, and thus strongly *relationship*-based, into systems that are more effectively *rules*-based?

In many of today's OECD countries the transformation from relationship- to predominantly 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 corporate capitalism on a global scale.

Today's developing countries must therefore face a challenge unknown to many OECD countries: How to move from heavily relationship- to effectively rules-based systems of corporate and public governance at a time when large private and state-owned corporations play a significant, often dominant, role in the local economy (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-control Rents

Both the importance, and the great 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 insiders are able to extract corporate-control rents (able to expropriate value) from other corporate stakeholders. While insiders' predictable reluctance to divulge the information needed to gauge the size of those rents makes them notoriously difficult to measure, the difference between the price paid for a controlling bloc of a company's shares and the price others were paying at the same time for the company's shares in the open market can be used as a crude objective indicator of those rents. During the 1990s, the difference averaged 33 per cent in Latin America (65 per cent in Brazil) and 35 per cent in central European transition economies (58 per cent in the Czech Republic, 11 per cent in Poland), for example, as compared to 2 per cent in South Africa, the United States and the United Kingdom, and 8 per cent in non-Anglo-Saxon Europe (1 per cent in Norway, 2 per cent in France, 37 per cent in Italy).

The other phenomenon is the often devastating impact of oligopolistic rivalry among powerful interest groups entrenched in local structures of economic and political power. Such groups generally include insiders in major private and public corporations. They 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 rent extraction *vis-à-vis* one another (i.e., their tendency to waste and consume significant resources), rather than invest those resources in the creation of new wealth for their national economies and themselves.

Pyramids, Cross-Shareholding, Multiple Share Classes

Three techniques are widely used throughout the developing world by insiders to expropriate or divert resources from corporations in ways that deprive non-controlling investors, and often 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 (e.g., 51 per cent, though less may suffice) in one or more other firms (the "second layer") each of which in turn holds a controlling share of one or more firms (the "third layer"), etc. Such pyramids allow the insiders who control the company at the top effectively to 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 of the pyramid – may be quite small. Also important are *cross-shareholdings* (firms possess each other's shares) and *multiple share-classes* (shares in the same company have different voting rights, with insiders' shares often having disproportionately high voting rights). Often used in combination, with cumulative effects, 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 these techniques to extract control rents and 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 including better corporate governance. Compared to sound local governance, these techniques offer dominant shareholder-managers (prevalent in much of the developing world) an *added* advantage, from their private perspective. Rather than having to dilute their effective degree of 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, in doing so, these techniques also create strong incentives for corporate insiders to pursue abusive self-dealing and related activities with the sizeable corporate resources they control. Not only do such activities constitute severe market distortions. Even worse, they lead corporations to behave in ways that significantly increase both rigidities *and* volatility in the local economy.

They create strong incentives for corporations to invest heavily in capital-intensive facilities that often remain significantly under-used in a context of economy-wide capital scarcity. They provide incentives for corporate insiders to pursue strategic rivalry among themselves that costs society dearly in terms both of 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 to explain their observed tendency to resist pressures to improve corporate governance in many developing countries. It also helps to explain the severe wastage, market distortions and often massive misallocation of resources, both human and material, 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 the vicious circle. To do 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 Centre's research and informal policy-dialogue on corporate governance, and the regional policy dialogue programmes organised by its Corporate Affairs Division 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 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 enhanced capacity to address the problem of insiders' abusive use of multiple share classes, cross-shareholding and pyramidal corporate control structures. In many countries it will require significantly greater public disclosure of effective share ownership, together with stronger measures to ensure the basic property rights of share 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 effectively to enforce them. Actually, many developing countries have too much and sometimes conflicting regulation that proves to be too difficult to enforce.

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

Many OECD countries favour 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 the appropriate balance between regulatory and voluntary initiatives. For developing countries, further questions can be raised as to the effectiveness of voluntary mechanisms, given their relatively weak institutions of rules-based governance in general, and weak third-party monitoring capabilities in particular. 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.

Regulatory and judicial institutions' role in public enforcement is thus particularly important for developing countries. Recent experience notably highlights the potential value for these countries of having a strong and politically independent yet fully accountable securities regulatory commission that is both 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 effectively a country's judiciary system.

Policy makers 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. Moreover, indeed, 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 (it notably includes the credibility of contract enforcement as a whole) but because of the danger that those with responsibility to regulate (e.g., the securities commission) may be corrupted or unduly influenced by those whose actions they are intended to monitor and regulate. And it is precisely in countries most burdened by the behaviour of powerful distributional coalitions – whose entrenchment is often also reflected in the very lack of independence and accountability of their country's judiciary – that the risk of corruption or excessive influence tends to be greatest.

Developing a competent, politically independent and well-funded judiciary is thus 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 strongly as well through relationship-based systems of *public* government. 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. The power of corporate insiders and their close relationship with those who exercise political power at the highest levels means that development requires moving from the rule of persons to the rule of law in the institutions of corporate and public governance together.

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