# OECD DEVELOPMENT CENTRE

## POLICY BRIEF No. 23

# CORPORATE GOVERNANCE
## in Developing, Transition and Emerging–Market Economies

*by*

**Charles Oman, Steven Fries and Willem Buiter**

- Sound national systems of corporate governance are essential for all countries, including the poorest, to reap the benefits of globalisation.
- "Corporate governance" comprises the institutions that govern the relationship between people who manage corporations and all others who invest resources in them.
- The quality of local corporate governance critically affects a country's ability to achieve sustained real productivity growth and the success of its long-term development efforts.
- Pyramidal corporate-ownership structures, cross shareholdings and multiple share classes are widely used by corporate insiders in the developing world to extract corporate-control rents, exploit other investors and resist pressures to improve corporate governance.
- The power of corporate insiders and their close relationship with those who exercise political power mean that sound corporate governance requires sound political governance, and vice versa.

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Corporate governance is important for the success of long-term development in developing, transition and emerging-market economies. The quality of a country's governance institutions – of which those of *corporate* governance now constitute an integral part – matters greatly for development as a whole. In all countries, and for all segments of a country's population, including the poor, the ability to move from heavily relationship-based to predominantly rules-based institutions of corporate, as well as public, governance is essential.

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## Introduction

Corporate governance was long ignored as a matter of potential importance for the development of a nation's economy. It remained virtually invisible as a development policy issue until the East Asian financial crisis of 1997-1998, followed closely by those in Russia and Brazil, drew attention to the problems of "crony capitalism" and their perceived relationship to poor local corporate-governance practices in several emerging-market economies. Yet as the perceived threat to global financial markets raised by those crises recedes and international pressures to strengthen corporate governance in emerging markets weaken, the danger is that local efforts significantly to improve corporate governance in the developing, transition and emerging-market economies will flag.

Those efforts need rather to be strengthened. EBRD experience in the transition economies and Development Centre research in developing countries, and OECD work on corporate governance as a whole, all show that sound corporate governance is vitally important – more so than is commonly perceived – for the success of long-term development efforts in those economies. It is important because virtually all developing, transition and emerging-market countries are going through a difficult process of transformation in which corporate governance plays a key role.

This transformation involves deep change in both the economic and the political spheres of national governance. Economically, the move is from relatively closed or inward-oriented and market-unfriendly systems to more open and market-friendly systems. Politically, it is from relatively undemocratic to more democratic systems. In both, the move is towards more functionally *rules*-based systems of governance, away from systems that were non-transparent and unaccountable and often heavily *relationship*-based.

## What is Corporate Governance?

"Corporate governance" comprises a country's private and public institutions, both formal and informal, which together govern the relationship between the people who manage corporations ("corporate insiders") and all others who invest resources in corporations in the country[1]. These institutions notably include the country's corporate laws, securities laws, accounting rules, generally accepted business practices and prevailing business ethics. To illustrate, Annex I provides a general, indicative list of key corporate-governance institutions, and core corporate-governance actors, found in many countries.

Perhaps more fundamental to understanding the meaning of corporate governance than any list of actors and institutions, however, is to understand the *purpose* of corporate governance. That purpose, in any country, is threefold:

- Facilitate and stimulate the *performance* of corporations by creating and maintaining incentives that motivate corporate insiders to maximise firms' operational efficiency, return on assets and long-term productivity growth;
- Limit insiders' *abuse of power* over corporate resources – whether such abuse takes the form of insiders' *asset stripping* or otherwise siphoning off corporate resources for their private use, and/or their causing significant *wastage* of corporate-controlled resources (the so-called "agency problems") – which are otherwise likely to result from insiders' self-serving behaviour;
- Provide the means to *monitor* managers' behaviour to ensure corporate accountability and provide for reasonably cost-effective protection of investors' and society's interests *vis-à-vis* corporate insiders.

The institutions of corporate governance serve, in short, both to determine what society considers to be the acceptable standards of corporate behaviour, and to ensure that corporations comply with those standards.

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1. Investors may include suppliers of equity finance (shareholders), suppliers of debt finance (creditors), suppliers of relatively firm-specific human capital (employees) and suppliers of other tangible and intangible assets that corporations may use to operate and grow.

## Why Corporate Governance Matters for Development

Corporate governance is often thought to be important mainly for companies with publicly traded shares that seek to raise capital from outside equity investors. Well-governed companies, it is thought (and the evidence suggests[2]), should be able to raise such finance at significantly lower cost to the company than poorly governed companies because of the added risk-premium investors can be expected to demand for investing in the latter – if they accept to invest in such companies at all.

In developing countries, the widespread preponderance of smaller firms that do not have listed shares, and of large family-owned, state-owned and/or foreign-owned companies whose shares are also not widely traded locally, is thus an important reason why the potential importance of corporate governance was long ignored.

Yet perceptions that corporate governance is of little importance for countries that do not have many companies with widely traded shares are mistaken. Such perceptions are wrong because the institutions of corporate governance lie at the heart of one of the greatest challenges that virtually all developing, transition and emerging-market economies now face: how to move successfully from institutions of economic and political governance that tend to be heavily relationship-based to institutions that are more effectively rules-based.

This move is particularly important, and difficult, both *i)* because of corporate insiders' widespread ability in developing, transition and emerging-market economies to exploit other investors and generate corporate-control rents (the "expropriation problem"), and *ii)* because of the widely damaging effects in those countries of negative-sum game rivalry among powerful interest groups entrenched in local structures of political and economic power – groups whose members often include insiders in large state-owned and/or privately owned corporations. The combined effects of the expropriation problem and vested-interest-groups' negative-sum game behaviour seriously hinder long-term productivity growth, and restrain long-term development, in many developing, transition and emerging-market economies.

2. See OECD (2003*b*) for a review of the evidence in OECD countries. See also Fremond and Capaul (2002).

The importance of corporate governance thus extends well beyond the corporate sector in developing, transition and emerging-market economies. Corporate governance matters not only because the health of a country's corporate sector matters for the country's entire economy (including its non-corporate sector) but because the quality of a country's institutions of governance (of which those of corporate governance now constitute an integral part) matters greatly for national development. The ability to move from heavily relationship-based to predominantly rules-based institutions of corporate as well as public governance is central to the success of the long-term development process in all countries.

### *Moving from Relationship- to Rules-based Governance*

Among the transition economies in which the EBRD[3] and the OECD[4] work, democratic revolutions gave power to new reforming elites in the Central European and Baltic (CEB) states. In some southeastern European (SEE) countries and many Commonwealth of Independent States (CIS), in contrast, the first post-communist governments were headed by the same political elites who ruled under communism. Transition reforms in both the economic and political spheres have thus progressed further in the CEB countries, where the new political leaders and the new elites supporting them were motivated quickly to introduce both democratic political reforms and market-friendly economic reforms (notably trade and price liberalisation and rapid small-scale privatisation) in order to limit the power of government bureaucrats and enterprise managers,

3. The EBRD assesses 27 transition economies' progress since 1989 in structural and institutional reforms which it summarises in the form of ordinal "transition indicators" that do not, however, cover such aspects of governance as business regulation, corruption, law and order, taxation and the two-way relationship between enterprises and the state. To cover these, in 1999 the EBRD and the World Bank launched the Business Environment and Enterprise Performance Survey (BEEPS) which asks business managers to evaluate economic governance and state institutions and to assess how and to what extent the business environment creates obstacles to the operation and growth of their firms. In 2002, a second stage of the BEEPS surveyed over 6 000 firms in the 26 transition economies. Results are reported in the EBRD's annual *Transition Report.*

4. Regional Corporate Governance Roundtables have been established by the OECD in co-operation with the World Bank Group for Russia, Eurasia and South East Europe, as well as for Asia and Latin America. With the exception of Eurasia, policy makers and concerned individuals participating in the Roundtables have produced White Papers, consensus documents that provide regional corporate-governance reform "action" plans. Experience from the Roundtables is summarised in OECD (2003*a*). See also Annex 2.

and prevent the re-emergence of a political monopoly. This approach has created a forward momentum in reform that has extended to various aspects of institutional change, including sound corporate governance.

A recent acceleration of progress in the SEE and CIS countries, since 1999, has allowed them partially to catch up with the CEB countries. Yet the SEE and CIS countries continue overall to lag behind, especially in the "second phase" reforms that involve institution-building. While free markets and private enterprise seem relatively well established now in most transition economies[5], progress in establishing democracy and political competition remains much more uneven, as does the process of international integration and, especially in the Caucasus and Central Asia, of enhancing trade and transit with immediate neighbours[6].

Similarly, in developing countries, the speed and sequence of transformation of national systems of economic and political governance vary among countries, as does the degree of overt and/or covert internal resistance to it; some countries are therefore relatively more advanced in one or both dimensions than are others. Such differences are visible among the countries whose corporate governance the Development Centre has examined[7]. Yet the key point is that notwithstanding their conspicuous differences – in culture and history (including legal heritage) and economic and political institutions – virtually all of today's developing and emerging-market economies, like the transition economies, are in the midst of a dual, often difficult, transition to more transparent, accountable, rules-based and market-friendly systems of economic and political governance.

In many countries, under the previous system, large private as well as state-owned corporations obtained long-term investment finance from state-directed or state-owned sources, such as the national development bank. Some of these countries achieved significant output growth through massive factor mobilisation (often involving forced saving along with major investment in human capital) yet few achieved *sustained productivity* growth in their corporate sector – a key to long-term national development[8].

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5. Belarus and Turkmenistan are exceptions, as is Uzbekistan to a lesser extent.

6. See also Pomfret (2003).

7. These include Brazil, Chile, China, India, Malaysia and South Africa. See Oman (2003), Thillainathan et *al.* (2003) and Lin (2001).

8. See Chapter 1 in Oman (2003) for further discussion of the importance of productivity growth for sustained development.

The weakening or collapse of those old systems – whether they were called import-substituting industrialisation, central planning or apartheid – and the moves underway to achieve more transparent and accountable systems of co-operation and competition among the key economic and political actors, may or may not be irreversible. They clearly constitute an important opportunity for needed change in governance structures.

### *The Expropriation Problem*

Much of the recent corporate governance debate has focused on the "principal-agent" problem that tends to plague the relationship between shareholders (the principals) and managers (the agents) owing to the separation of ownership and management (or control) in companies with widely dispersed "public" ownership of shares – companies in which no single shareholder owns more than a small fraction of the firm's stock – as prevailed in the United States and the United Kingdom for much of the 20th century. Based largely on the experience of these two countries, many authors have come to argue that the purpose of corporate governance is to protect the interests of shareholders, because the interests of other investors can be protected through contractual relations with the company, leaving shareholders as the "residual" claimants whose interests can adequately be protected only through the institutions of corporate governance[9].

Yet in many developing, transition and emerging-market countries, pervasive clientelism ("cronyism") and/or weak judicial systems, and often poorly defined property rights, tend greatly to weaken effective contract *enforcement*. Poor contract enforcement in turn renders the distinction between "residual" and non-residual claimants of doubtful applicability in practice. Even authors who firmly adhere to the logic of this distinction tend to argue, for example, that weak bankruptcy procedures create a need for corporate governance to include protection of creditors' interests in most of those countries[10].

The existence of institutional infrastructure that is crucial for any country's system of corporate governance, and which can largely be taken for granted in OECD countries (e.g. widely recognised and enforceable property rights, reasonably well-functioning legal, judicial and public regulatory systems), cannot, in sum, be taken for granted in many developing, transition and emerging-market economies.

9. See for example Shleifer and Vishny (1997).

10. These concerns have also been taken up in the Regional White Papers (cf. Annex 2).

Equally crucial is the fact that outside the United States and the United Kingdom, widely dispersed corporate ownership is not the rule but the exception. What prevails in most developing, transition and emerging-market economies (as in many OECD countries) is the corporation with *concentrated ownership*, i.e. dominant shareholders – "blockholders" – who directly control managers[11]

Perhaps even more important (though less widely discussed) than the concentration of corporate ownership per se, moreover, is the prevalence in many developing, transition and emerging-market economies of *cross-shareholdings* among companies; the issuance of *multiple classes of shares* with different voting rights in a given company; and *pyramidal corporate ownership structures*[12]. These are all means used by dominant owner-managers to control corporate assets considerably greater, even, than their direct stock ownership rights would justify[13].

The key potential conflict of interest in developing, transition and emerging-market countries therefore tends to arise, not between managers and shareholders as such (as in the United States and the United Kingdom), but between *controlling* shareholders on one hand and *minority* shareholders (domestic and foreign), and other investors, on the other.

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11. See for example, La Porta *et al.* (1998*a*), for evidence on corporate ownership patterns around the world. Note also that while the lack, or underdevelopment, of institutional infrastructure required for better corporate governance may well go far to explain why many controlling shareholders do not diversify their equity holdings (and by not diversifying, they also forego the possibility to reduce their exposure to risk) and thus be an important cause of concentrated corporate ownership structures in many of these countries (see for example, Shleifer and Vishny, 1997), one should not underestimate the possibility that a strong reverse causal relationship is also at work.

12. A "pyramid" exists when one corporation (at the top of the pyramid) holds a dominant equity share (say, 51 per cent, though less may suffice) in and thereby controls one or more other companies (the second "layer" in the pyramid) each of which may in turn have a dominant equity share in one or more additional companies (the third layer), and so on. Corporate insiders who effectively control the corporation at the top of the pyramid – often a holding company – can thus control entire groups of corporations, and massive corporate assets, with very little direct equity ownership in corporations lower down in the pyramid.

13. This phenomenon is known in the literature as effective "control" rights that exceed nominal "cash-flow rights". Bebchuk *et al.* (1999) demonstrate why, when pyramids, cross-shareholdings and/or multiple-class shares are used by corporate insiders to increase their control rights beyond their cash-flow rights, the result tends to be expropriation costs that are "very large…an order of magnitude larger [even] than those associated with controlling shareholders who hold a majority of cash-flow rights."

This conflict of interest is commonly referred to as the *expropriation* problem, because of the tendency for dominant owner-managers to take advantage of their effective control over corporate resources to expropriate or divert resources from the corporation in ways that deprive minority shareholders, and often other investors, of what would otherwise be considered their fair share of income from those resources. The expropriation problem, as distinct from the "agency" problem, tends to prevail, worldwide, in countries with highly concentrated structures of corporate ownership. It tends to be amplified and aggravated by controlling shareholders' widespread use of multiple classes of shares, cross-shareholdings and pyramidal ownership structures. These techniques not only allow a relatively small number of controlling shareholders to control corporate assets worth considerably, sometimes vastly, more than their own wealth (more than their "cash-flow rights") would justify. Pyramids, cross-shareholdings and multiple share-classes widely serve also to provide corporate insiders with access to significant financial resources, including those expropriated from other investors.

A further consequence of the widespread use of pyramidal corporate ownership structures, cross-shareholdings and multiple share-classes has thus been to reduce or eliminate the financial pressure on corporate insiders significantly to improve corporate governance[14]. Whether or not they give lip service to the need for such improvement, the extent to which corporate insiders benefit from corporate control-rents helps explain why they commonly resist it in practice.

Table 1 provides an indication of such rents in the amounts reportedly paid for controlling shares in corporations in 15 developing, transition and emerging-market economies, and 14 OECD countries, during the years 1990-2000.

14. Dominant shareholder-managers may, in other words, use multiple-class shares, cross-shareholdings and especially pyramidal corporate ownership structures (individually and in combination, with cumulative effects) as functional substitutes for the development of a more rules-based national financial market – substitutes which have the added advantage, for the dominant shareholder-managers, that rather than diluting their effective degree control over a corporation, as would occur with the sale of equity to raise funds from extra-firm sources, they actually *increase* it, sometimes considerably, beyond their nominal share of equity. See also Oman (2003) and OECD (2003*a*).

Table 1. **Value of Corporate Control**
(premia paid for control blocs of companies' shares as % of open-market value of companies' equity)

**Developing, Transition and Emerging-Market Countries**

| **Latin America** | mean | (no. obs.) | **Asia** | mean | (no. obs.) | **Transition** | mean | (no. obs.) | **Africa** | mean | (no. obs.) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Argentina | 27 | *(5)* | Hong Kong, China | 1 | *(9)* | Czech Republic | 58 | *(6)* | South Africa | 2 | *(4)* |
| Brazil | 65 | *(11)* | Korea (Rep.) | 16 | *(6)* | Poland | 11 | *(5)* | | | |
| Chile | 15 | *(9)* | Malaysia | 7 | *(41)* | | | | | | |
| Colombia | 27 | *(5)* | Philippines | 13 | *(15)* | | | | | | |
| Mexico | 34 | *(5)* | Singapore | 3 | *(4)* | | | | | | |
| Venezuela | 27 | *(4)* | Thailand | 12 | *(12)* | | | | | | |
| Total (Latin America) | 33* | (39) | Total (Asia) | 9* | (87) | Total (Transition) | 35* | *(11)* | | | |
| Total for Dev., Trans. & Em-Mkt countries | | | | 21* | *(141)* | | | | | | |

**OECD Countries** (other than listed above)

| **Continental Europe** | mean | (no. obs.) | **Other OECD** | mean | (no. obs.) |
|---|---|---|---|---|---|
| Denmark | 8 | *(5)* | Australia | 2 | (13) |
| Finland | 2 | *(14)* | Canada | 1 | (4) |
| France | 2 | *(5)* | New Zealand | 3 | (19) |
| Italy | 37 | *(8)* | United Kingdom | 2 | (43) |
| Netherlands | 2 | *(5)* | United States | 2 | (47) |
| Norway | 1 | *(14)* | | | |
| Spain | 4 | *(5)* | | | |
| Sweden | 6 | *(13)* | | | |
| Switzerland | 6 | *(8)* | | | |
| Total (Continental Europe) | 8* | *(77)* | Total (other OECD) | 2* | (126) |
| Total for OECD countries | 6* | *(203)* | | | |
| Total for all countries | 14* | *(344)* | | | |

mean = arithmetic mean of control-bloc premia that were calculated in a country; no. obs = number of control transactions for which premia were calculated.
* = unweighted average of national mean values.

*Note:* The value of a control-bloc premium is calculated for an individual company (at the time of the control transaction) by calculating the difference between the price per share reportedly paid for the control bloc and the open-market exchange price of the company's shares observed two days after the announcement of the control transaction (dividing that difference by the exchange price and multiplying the ratio by the proportion of cash flow rights represented in the controlling bloc). All transactions occurred between 1990 and 2000.

*Source:* Adapted from Table II in Dyck and Zingales (2002).

***Vested Interests***

In many developing, transition and emerging-market countries the effects of the expropriation problem are severely exacerbated, moreover, by the destructive, often acutely negative-sum game, behaviour of powerful vested interest groups that are entrenched in highly concentrated oligopolistic structures of local *political* as well as economic power[15]. Particularly damaging is often the considerable extent to which the behaviour of such powerful local groups (closely tied to foreign investors in some countries, less so in others) serves to weaken or undermine healthy price competition and the proper functioning of markets – which are indispensable for a country to achieve reasonably sustained productivity growth – as well as to weaken or undermine the development and consolidation of democratic political institutions.

The significant moves in many countries – developing and emerging-market as well as transition countries – to privatise formerly state-owned corporations, to reduce anti-competitive market regulations, to liberalise trade and investment policies, and to attract foreign investors are having a major positive impact. But those moves may not be sufficient on their own to create the kind of dynamic and interactive processes of long-term productivity growth and political as well as economic-policy reforms which these countries need to achieve, and sustain, in order successfully to carry forward their struggles against poverty and corruption, and for the strengthening of political democracy and modernisation of the state. For these countries, even more than for OECD countries, institutions of corporate governance that work effectively to complement and reinforce the (still weak) competitive market mechanism and (fledgling) democratic political institutions are becoming increasingly necessary.

They are crucial, first, because in all market-based economies the firm is, and over the last century the corporation has become, society's principal agent of economic activity and development. The institutions of corporate governance – combined with those of market competition and government regulation – are society's principal means of motivating corporations collectively to behave in ways that are good for society as a whole. These institutions embody a principal-agent relationship between society (the principal) and corporations as a group (the agents): society provides corporations with the incentive to act (notably the

15. Those structures of power are widely reflected in the structure of corporate ownership, often visible in the importance of state-owned enterprises as well as of large private family-owned business groups.

right to earn profits) and the means to do so (notably the right to exist and to act as "legal persons" separate from their shareholders, and to benefit from limited shareholder liability), and seeks, in return, through the institutions of corporate governance (along with those of market competition and government regulation), to ensure that corporations collectively serve its best interests[16].

Today, as globalisation enhances the strength of market forces relative to that of regulation by national and sub-national governments, corporate governance has become even more important than during the postwar period. In many developing, transition and emerging-market economies two additional phenomena amplify this increased importance of corporate governance even further. One (a positive phenomenon) is the sea change many of these countries have undertaken in recent years to move to more market-friendly policy regimes. The other (a negative phenomenon) is the continued pervasiveness of *concentrated oligopolistic local power structures*[17] – structures that are highly conducive *to self-dealing*[18] and other such rent-seeking behaviour by corporate insiders who widely exercise power in both the private and public sectors.

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16. In the United States, where the right to incorporate is granted by state governments, not by the federal government, corporate charters were granted until late in the 19th century under far more stringent conditions than they are today – usually on the understanding that demonstrable public good would result from the corporations' activities. As corporations came to be seen less as agents of the public interest, however, and states came to presume (rather than demand proof of) public benefits from business enterprise, and as a growing number of firms became sufficiently national to have practical choices about which state to call home, the specific terms of state chartering came to matter more. In 1896, New Jersey then adopted aggressively liberal chartering rules, and became the legal home of choice for major corporations. New Jersey nevertheless shifted to a somewhat tougher chartering law in 1913, and rapidly lost its hegemony to Delaware, which had altered its own incorporation provisions to mirror New Jersey's previous law. Delaware has tenaciously defended its dominant place in corporate chartering ever since.

17. For an analysis of the significant potential cost to a country in terms of the performance of its system of corporate governance of an *oligopolistic*, as opposed to a functionally *monopolistic*, local power structure see Meisel (2003).

18. "Self–dealing" is the expropriation or diversion by corporate insiders of a corporation's assets (sometimes also called "asset stripping") and/or of its income or income–earning possibilities. Common forms, or means, of self–dealing include having the corporation purchase inputs from one or more other firms (presumably also controlled by the corporation's insiders or their close friends or relatives) at excessively high prices, or sell output at excessively low prices; having the corporation borrow money at excessively high interest rates, or lend at excessively low rates; having it lease assets at similarly non–market rates; having it guarantee other companies' (or individuals') borrowing; or even outright appropriation of the corporation's tangible and/or intangible property without compensation.

The widespread consequences of that behaviour (discussed again below in the section on obstacles to needed change) are huge wastage of corporate-controlled resources and highly inefficient economy-wide use of capital (i.e. major dynamic inefficiencies, including forgone innovation and investment in new capabilities, on top of static misallocation) along with a perpetuation or exacerbation of local inequalities. A further widespread consequence is both excessive *resistance to needed change*, reflected in excessive *rigidity*, and simultaneously (paradoxical though it may seem), excessive *volatility*, in both the political and economic spheres of power and decision making. The combined result is to constitute a very serious hindrance to a country's long-term development[19].

While the potential contribution of improved corporate governance to increasing the flow and lowering the cost of domestic and foreign *financial* resources to corporations is significant, equally if not more important, therefore, is its potential contribution to reducing the considerable wastage and misallocation of *real* investment resources – human and physical – and to overcoming perpetuation of the often highly negative-sum games of strategic rivalry among distributional cartels. Such wastage and misallocation, and perpetuation of the status quo, can constitute a major constraint on sustained productivity growth, and thus on a country's long-term development.

## Forces Working *For* and *Against* Improved Corporate Governance

Strong forces have built up in recent years that work both for and against significant improvements in corporate governance in developing, transition and emerging-market economies. Particularly important among those working in favour of improvements are both the rapid growth of institutional investors, in OECD countries and in a growing number of developing, transition and emerging-market countries, and a combination of factors that have greatly increased corporate demands in the latter countries for investment funds from non-traditional extra-firm sources. Particularly important among the forces resisting improved corporate governance, on the other hand, are entrenched interest groups that benefit from corporate-control rents.

19. See Oman (2003), OECD (2003*a*) and CIPE (2002).

### *Institutional Investors*

In OECD countries, the growing interest in corporate governance preceded the recent corporate scandals associated with such names as Enron, WorldCom, Tyco, Vivendi, Marconi, Ahold and Arthur Andersen (although the scandals have certainly heightened the interest[20]). An important reason for the interest has been the spectacular growth of portfolio investments in corporate equities both at home and abroad by rapidly growing pension funds and other major institutional investors.

The rapid growth of international portfolio investment by OECD-based (particularly US and UK) institutional investors is in turn reflected in, and largely responsible for, the significant growth of international portfolio investment during the 1990s. Portfolio equity investment flows to non-OECD countries rose from insignificant levels prior to the late 1980s to an annual average of $2.7 billion in 1989-1990 and then surged in 1993-1996 to an annual average of well over $40 billion (an amount almost equivalent to global official development assistance). Dropping to about $17 billion in conjunction with the Asian, Brazilian and Russian "emerging-markets financial crisis" in 1998, they climbed back to some $40 billion in 2000 before declining again owing mainly to the sharp decline in OECD stock markets and a general flight from equities by OECD investors[21].

OECD-based portfolio investors, in particular the major institutional investors, have thus been an important force working in favour of improved corporate governance in emerging-market economies during the 1990s, and are likely to continue to be so in the future.

Also important though perhaps less widely perceived has been the establishment and growth of *domestic* pension funds in developing, transition and emerging-market countries. Chile's 1981 creation of a fully funded, privately managed pension system with individualised mandatory savings accounts was followed in the 1990s by the creation or significant development of such "funded" (as opposed to "pay as you go") pension funds in close to 30 countries outside the OECD region[22]. While these funds remain small compared with the largest OECD-based institutional investors, many have been important purchasers

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20. See, for example, the survey on "Capitalism and Democracy" in *The Economist*, 28 June 2003.

21. See Reisen (2003).

22. See also Queisser (1999).

(along with foreign investors in some countries) of domestic corporate equity issues, notably in conjunction with local moves to privatise state-owned enterprises. These domestic funds constitute a significant current or potential force – arguably the single most important one in the long run[23] – for improved corporate governance in developing, transition and emerging-market countries.

### *Demand for Funds*

If foreign and, in a growing number of countries, domestic institutional investors (pension funds in particular) have become an important force for improved corporate governance as potential suppliers of funds, equally important is the fact that numerous corporations in developing, transition and emerging-market economies have increased their demand for funds in recent years.

One reason for this demand growth – notwithstanding the ubiquitous use of pyramids, cross-shareholdings and multiple share-classes noted earlier – is the considerable increase in the needs of corporations, in all countries, for extra-firm sources of finance to be able adequately to respond to the growing competitive pressures engendered by globalisation. The acceleration of change (in technology, but also in the dominant business model[24]) has required most firms, worldwide, to undertake major investments – and often continues to require large investments – in tangible and intangible assets (including human capital and technology), for which finance must be found, in order to remain or become competitive. In many countries it has also been an important factor behind the drive to privatise poorly performing state-owned enterprises.

The significant moves to liberalise trade and investment policies and deregulate markets – a sea change for many developing and emerging-market as well as for the transition economies – have added greatly to these competitive pressures, as has the significant privatisation of state-owned enterprises in some. Deeper international integration (doubly intense in EU-accession candidates among the transition countries) has further increased competitive pressures on firms, and thus increased their demands for extra-firm sources of finance capital, as well.

23. Malherbe (2003) makes this point. He also provides a useful typology of the corporate-governance capabilities of domestic pension funds in 29 countries: Argentina, Bolivia, Brazil, Brunei, Chile, Columbia, Croatia, Cyprus, El Salvador, Hong Kong, India, Indonesia, Kazakhstan, Kenya, Malaysia, Mexico, Nepal, Papua New Guinea, Peru, Poland, Singapore, South Africa, Sri Lanka, Swaziland, Tanzania, Uganda, Uruguay, Zambia and Zimbabwe.

24. On the central role of a new business model in driving the current wave of globalisation and regionalisation, see Oman (1996*a*, 2000).

A further, crucial reason why the extra-firm financial needs of corporations in developing, transition and emerging-market economies in particular have increased is that, in many, the bulk of those needs used to be supplied (especially for *large* private companies as well as for state-owned firms) by national development banks and other largely state-controlled sources of investment finance (often through various forms of forced saving). Many of these countries have witnessed the relative collapse or even the disappearance of the relationship-based and politically directed financial systems, thus greatly reducing their ability to supply long-term finance to local corporations (often in the name of "industrial policy") as they did previously[25].

The combined result, in the 1990s, was thus a marked decrease in the supply of extra-firm investment finance from traditional domestic sources precisely at a time when corporate extra-firm financial needs in those countries rose substantially. The result has thus also been to increase domestic pressures, within governments as well as among corporate insiders, in favour of improved corporate governance in order to facilitate the flow of investment finance to local corporations.

It was in this context and with a view to promoting improved corporate governance that in 1997 the EBRD also developed its Guidelines on Sound Business Standards and Corporate Practices, and in 1999 the OECD agreed its Principles of Corporate Governance and, in collaboration with the World Bank, launched the first Regional Roundtables, as briefly presented in Annex 2.

### *Obstacles to Improved Corporate Governance*

Significant resistance to the changes required in order markedly to improve corporate governance is nevertheless widespread. Vested-interest groups that benefit from corporate control rents – at the expense of minority shareholders and other corporate stakeholders, both local and foreign, as discussed earlier[26] – are a major source of resistance to needed change.

25. See also Loriaux *et al.* (1997).

26. A good illustration is the case of Brazil, where the *average* level of corporate-control rents was recently estimated at 65 per cent of corporate value. See the chapter on Brazil in Oman (2003). See also OECD (2003*a*).

In seeking to maintain or increase their share of a country's wealth, these groups – "distributional cartels" as Mancur Olson called them[27] – often invest significant corporate-controlled and/or government-controlled resources, not in the creation of new wealth, or in the provision of public goods needed for the creation of new wealth, but in actions of strategic rivalry among themselves. Those actions – both to manipulate the role of the state to their private economic advantage, and to use corporate resources to increase their share of political and economic power – tend not only to stifle healthy inter-firm price competition and to siphon off significant resources for the oligopolistic rivals' private benefit. They tend also to *consume* significant resources in their actions of strategic rivalry. The result can be huge wastage and misallocation of a country's resources – real (physical and human) and financial – which in turn reduces aggregate wealth and constitutes, for the economy as a whole, a highly negative-sum game set of dynamics that greatly hinders long-term productivity growth.

Even more harmful than the widespread *monopoly* powers of such groups, which tend to be reflected in forgone investment and innovation compared with what one would find in a more price-competitive context[28], in other words, is often the destructive strategic behaviour of rival distributional cartels that operate simultaneously in the economy, notably as corporate insiders, and in domestic politics in a context of concentrated *oligopolistic* local power structures.

Two "paradoxes" found in many developing, transition and emerging-market economies illustrate well the kind of effects that such oligopolistic rivalry among distributional cartels typically produces. One is a propensity for large private and state-owned corporations alike to undertake major, often highly capital-intensive, investments in production capabilities that remain significantly under-used (i.e. a propensity to undertake costly investments in over-capacity) in countries that, virtually by definition, suffer from relatively acute capital scarcity. The other

27. Olson (1982) provides a detailed analysis of the behaviour of "distributional cartels", albeit in OECD countries. Olson explains why such a group will tend to undertake actions (to gain, say, $2 billion in increased income or wealth for the group) that often cost society as a whole much more than the group itself stands to gain (cost society the equivalent of, say, $10 billion in wasted resources, reduced income and lost growth opportunities).

28. Similarly, capital intensive processing of natural resources is often undertaken in OECD countries with sound institutions rather than in the countries where the natural resources are located. One such example is the extensive processing of Russian timber in Finnish mills with some of the final products being re-exported to Russia.

common "paradox" is a tendency for large corporations operating in oligopolistic local market structures to *resist needed change* (notably in response to new conditions created by the availability of a new technology, changing consumer preferences and/or the advent of a more competitive business model) and, simultaneously, to *create excessive volatility* in markets, and often in politics as well – volatility that can even lead, in more extreme cases, to armed violence.

The reason for this behaviour, put simply, is that in their games of strategic oligopolistic rivalry distributional cartels tend, on one hand, to *resist* inter-firm price competition and any (needed) change that might upset the balance of power within their oligopoly. Yet, on the other hand, they are simultaneously prone to *provoking* (unneeded) change whenever a member of the cartel or coalition of members within the cartel believes it can increase its share of power (e.g. product-market share, share of corporate-control rents, etc.) *vis-à-vis* other members of the cartel.

The combined result for the country, in sum, tends to be:

- very significant wastage of capital resources, both material and human;
- forgone investment in capabilities needed to compete in global markets;
- a building-up over time of bureaucracy and resistance to change in corporations and government alike; and
- instability or volatility and thus fragility in both the economy and local political institutions.

A further result in many countries is a tendency to reproduce clientelistic relationship-based forms of both corporate and political governance that are insufficiently transparent and accountable[29]. And clientelistic relationship-based systems of governance are particularly fertile breeding grounds for distributional cartels. The overall result is thus often a vicious circle in which heavily clientelistic relationship-based governance systems breed – and make it particularly difficult to overcome – harmful forms of strategic oligopolistic rivalry among distributional cartels whose effects constitute a tremendous drag on economic growth and national development. That behaviour also makes it very difficult to bring about the changes needed to improve both corporate and public governance, and thus successfully to make the move from predominantly relationship-based to more effective rules-based systems of governance. Such a move is nevertheless crucial

29. See Oman (2003) and OECD (2003*a*).

to reducing corporate-control rents and limiting or overcoming the most damaging effects of the strategic rivalry among distributional cartels that constitute such a hindrance to sustained growth and development.

Powerful distributional cartels operate in all countries, of course, including OECD countries. Yet it is arguably the greater pervasiveness of their rent-seeking and negative-sum game behaviour in many developing, transition and emerging-market countries – to a point where it can easily overwhelm the benefits of healthy price competition in the economy as a whole – that constitutes the greatest obstacle to long-term productivity growth in these countries.

## Implications for Action

The policy challenge, in a nutshell, is to break out of the vicious circle just described. To do so requires policy makers' and regulators' attention to the role of corporate governance both in the financial sector and in the "real" (non-financial) sector of an economy. In both sectors, it requires their attention not only to the institutions of corporate governance but to the dynamics of interaction between those institutions and other key institutions and policies. And, more broadly, it requires attention to the dynamics of interaction between the institutions of corporate governance and those of political, or public, governance.

We look first at the financial-sector policy implications of the potential for corporate governance to enhance corporate performance – widely perceived as the *raison d'être* of corporate governance. This discussion will reflect the fact that the potential contribution of improved corporate governance to enhancing the supply of long-term investment finance tends to be less important, and its potential contribution to an economy's overall liquidity more important, than is widely recognised. We then focus on two key enforcement issues – voluntary versus mandatory and judicial versus regulatory enforcement mechanisms – which are as important for enhancing corporate performance in the real sector as for enhancing the financial role of corporate governance. Following that we turn more specifically to the real-sector implications per se, i.e. further policy implications of the potential for improved corporate governance to help strengthen long-term productivity growth in the real economy. We also look briefly at the relationship between corporate governance and political governance.

### *Financial Sector Implications*

To clarify the appropriate role for policy with respect to the potential for improved corporate governance to help channel finance to firms, it is important first to clarify – and thus avoid common erroneous assumptions about – the importance of equity capital, and the sale of shares, as a source of corporate finance. This question can in turn usefully be thought of as comprising two parts.

First, what is the importance of finance derived from the sale of new equity issues relative to that derived from other sources, notably intra-firm sources (mainly retained earnings) and extra-firm debt (both "intermediated" debt, notably bank loans, and non-intermediated debt, i.e. the sale of bonds and other debt securities)? Second, do corporate insiders widely desire to sell more equity than they are able to sell (the latter perhaps because of poor corporate governance), or rather do they generally *choose* not to sell more equity than they do?

A further question, also crucial from a policy perspective, is how do firms generally *use* whatever funds they raise through the (primary) sale of shares? In particular, are new equity issues used largely to finance the creation of new production capabilities – thereby also perhaps adding to competition in local product markets – or do they tend, rather, to be used by corporate stock issuers to absorb competitors without creating new production capabilities – perhaps serving even to reduce local competition as well?

The evidence suggests that, overall, the issuing of corporate equity is *not* a major source of funding for the creation of new production capabilities. This pattern of finance (in which internal sources are most important by far, followed by debt), which was largely characteristic of the historical experience of OECD countries, is widely visible today in developing, transition and emerging-market economies[30]. The pattern is consistent both with the well-known "pecking-order" theory of corporate finance[31], and with the apparent widespread use of pyramids, cross-shareholdings and multiple share-classes as a functional substitute for more rules-based financial markets in many developing, transition and emerging-market economies – as noted in our discussion of the expropriation problem.

30. See Oman (2003). South Africa has been something of an exception.

31. See Myers and Majluf (1984).

Concentrated corporate ownership structures can of course be understood, as many authors point out, as an appropriate response to serious potential agency problems in countries where there is poor corporate governance and, especially, poor protection of (minority) shareholders' rights[32]. The widespread separation of corporate ownership rights from effective control over corporate resources (with the latter exceeding the former) by dominant shareholders nevertheless means, it bears emphasising, that concentrated ownership may well not deprive corporate insiders of access to significant extra-firm finance. The use of pyramids, cross-shareholdings and non-voting shares to increase their control over corporate resources may not only allow controlling shareholders to retain full corporate control. It may also constitute a powerful source of financial leverage – as well as a functional alternative to improved corporate governance and better protection of minority shareholders' rights – by allowing corporate insiders to gain access to extra-firm sources of investment finance from minority shareholders, and other investors, while effectively retaining full control.

Contrary to common assumptions about the importance of primary equity sales as a source of corporate finance – assumptions which also have important implications for the extent to which corporate insiders are ultimately likely, or not, to be motivated on their own to improve corporate governance – the most serious problem driving the imperative to improve corporate governance in many developing, transition and emerging-market economies today may not be a shortage of corporate finance as such. Rather, from a policy perspective, the driving imperative is more the extent to which the ubiquitous use of devices to separate corporate ownership rights from the control of corporate resources serves to facilitate and camouflage *self-dealing* and related rent-seeking behaviour – and the negative-sum game dynamics reflected in such behaviour – by corporate insiders. Though difficult to measure, the costs to the economy as a whole – in terms of wasted resources, excessive rigidity, lost growth opportunities, excessive volatility and forgone development – undoubtedly go well beyond those incurred by expropriated minority shareholders alone.

From a policy perspective, measures to reduce and ultimately eliminate the use of shares with different voting rights, cross-shareholdings and, especially, pyramidal corporate ownership structures are thus vitally important – more so than is commonly perceived. Equally important are effective measures directly

32. See also Shleifer and Vishny (1997) and Rajan and Zingales (1998*a*).

to combat *self-dealing* by corporate insiders, notably through greatly enhanced *disclosure* and *transparency* requirements[33]. Closely related are the challenges of enforcement, to which we return shortly.

*Liquidity*

In seeking to protect minority shareholders' rights (and thus reduce the expropriation problem) it is nevertheless important not to ignore the potential economic benefits that can result from the separation of ownership and management – if and when a country's institutions of corporate governance are strong and credible enough to make this separation widely possible.

One such benefit stems from the fact that the atomising of equity claims into small, affordable units may make it possible to mobilise substantial amounts of capital from a multitude of small shareholders. Corporate enterprises are no longer always forced to find a wealthy individual, institutional investor or small group of wealthy investors to fund every new venture.

Also important is the possibility for shareholders to diversify their corporate equity holdings and thus reduce their level of exposure to risk by spreading their holdings. As shown by the experience of the United States in the late 19th and early 20th centuries, when the effective separation of ownership from management in many large industrial corporations made it possible for shareholders (often led by the corporate founder-owners themselves or their immediate heirs) to spread their investment risk, a self-reinforcing process – a virtuous circle – can emerge to increase greatly the *liquidity* of the local stock market. That enhanced liquidity can in turn make it possible for the stock market to play an important role in strengthening and enhancing the efficiency of the nation's entire financial system, and thus significantly enhance the broader process of national development.

Recent studies have shown that it is indeed much more the degree of liquidity than the size per se of equity markets (turnover rather than market capitalisation) that strongly correlates, positively, with the strength of a country's subsequent economic growth[34]. Thus, for example, whatever the potential long-term development benefits for a country of its having a vibrant stock market – vibrancy to which improved corporate governance could in turn be expected

33. See also OECD (2003*a*).

34. On the importance of a country's financial-markets development for its long-term economic development, see for example Berthélemy (2002), Levine and Zervos (1998) and Rajan and Zingales (1998*b*).

significantly to contribute – those benefits appear likely to be more a consequence of the market's contribution to enhancing the liquidity of the country's overall financial system, than of its contribution to corporate finance per se. More important for long-term national development than the primary market, in other words, may well be the secondary market, because of the importance for national development of enhanced liquidity in the economy as a whole.

*Banks and Markets: Complements*

A further key implication for policy makers is thus that measures to strengthen a country's system of corporate governance should be understood as a potentially important complement to, but not as a possible substitute for, measures needed to strengthen its banking sector. A country cannot have a strong and vibrant stock market without a strong, healthy, commercial banking sector. Indeed, for small and medium-sized local firms in particular, and for assuring liquidity in a country's financial system – including in low-income countries – a healthy banking system is a *sine qua non* for development[35].

An important implication for policy makers and regulators is thus also the need for careful attention to the quality of bank supervision and prudential requirements, as well as to bankruptcy rules and procedures[36]. Often equally important is the need to enhance the corporate governance of local *financial* institutions, notably including that of banks, and of domestic pension funds[37]. The latter in turn implies a need for attention to corporate disclosure requirements, the quality of auditing, etc., in the financial sector – both banks and long-term lending organisations, whether publicly or privately owned – as well as in the real sector.

35. The Asian White Paper also underlines this point.

36. See for example the chapters on Brazil, Chile and India in Oman (2003).

37. The considerable volume of recent literature addressing the question of whether countries should follow the route of the so-called bank-led system of corporate governance or rather that of the so-called Anglo-Saxon equities-based system may thus be addressing something of a false dichotomy (see e.g. Carlin and Mayer, 1999).

Experience also suggests that major business groups that are active in the real sector should not be allowed to have banks as members of their groups[38]. And it appears advisable to impose an effective separation between commercial and investment banking activities in most developing, transition and emerging-market economies[39].

*Professionalisation of Management*

A further potential benefit from the separation of control and ownership is the professionalisation of corporate management. This is a challenge many developing, transition and emerging-market countries face, whether in the context of privatisation of state-owned enterprises (sometimes referred to as "agents without principals"[40]) or in the transmission of family-owned corporations from one generation to the next. The challenge is both to expand the pool of qualified managers, and to develop a reasonably competitive market for management competencies.

Evidence from the move in some countries (e.g. China) to "corporatise" state-owned companies highlights another dimension of this challenge, because as managers of "corporatised" state-owned enterprises have gained greater autonomy, they have often used it to manage badly, i.e. waste resources and/or engage in self-dealing[41]. Legitimate concerns have thus also been raised that calls for greater professionalisation of management in some countries may be driven more by managers' desires to increase their autonomy, and thus increase their freedom from accountability, than by any commitment to increasing their level of professional standards.

***Enforcement***

Two critically important sets of policy issues stem from the importance of enforcement, and the fact that while many countries now have good corporate-governance laws and regulations on the books, their enforcement often remains

38. See in particular the chapter on Chile in Oman (2003). See also OECD (2003*a*).

39. See also for example Blommestein and Spencer (1993) and Glaeser *et al.* (2000).

40. See for example the chapter on India in Oman (2003).

41. See Lin (2001).

woefully inadequate[42]. Indeed, enforcement lies at the heart of the very distinction between rules-based and relationship-based systems of governance. It also lies at the heart of the concept of corporate governance.

The two sets of issues, which are as relevant for enhancing the contribution of corporate governance to the real economy (discussed further below) as for enhancing its contribution to the financial sector, are: *i)* how best to combine – and where to draw the line between – voluntary and mandatory mechanisms of corporate governance and *ii)* how best to combine judicial and regulatory means of enforcement.

*Voluntary vs. Mandatory Mechanisms*

On the question of voluntary versus mandatory mechanisms, some OECD countries (notably the United Kingdom) have found that a good general approach is one that emphasises disclosure. Put simply, the approach combines clearly defined and relatively demanding *mandatory* disclosure requirements – notably including the disclosure of a firm's degree of compliance with key, specified, *voluntary* codes or standards of disclosure on specific types of financial and non-financial information, and of the firm's reasons for any non-compliance (the so-called comply-or-explain principle) – with an otherwise heavy reliance on *voluntary* enforcement mechanisms. A major potential advantage of this approach is that it promotes managerial transparency, which is necessary for accountability, while simultaneously allowing maximum leeway for managerial discretion and flexibility. With globalisation, combined with the sea change in policy regimes referred to earlier, flexibility has become as important for firms in developing, transition and emerging-market economies as it has for firms in OECD countries to be able quickly to respond to accelerated change in their competitive environment.

It is doubtful whether such a disclosure-centred approach that relies rather heavily on voluntary enforcement is directly applicable in countries whose institutions in general, and third-party monitoring capabilities in particular, are relatively weak. Yet the distinction between voluntary and mandatory mechanisms is also not as clear-cut in practice as it might seem in theory. The principal reason is that legally mandatory rules often depend, in practice, on significant private monitoring and/or enforcement capabilities. Nor should such dependence be interpreted as a sign of public weakness; on the contrary, by delegating key

42. See OECD (2003*a*).

monitoring and enforcement responsibilities to specified private individuals and organisations, and then monitoring and holding them appropriately responsible for outcomes, governments and public regulators can often increase their effectiveness while significantly lowering their costs[43].

Still, such private monitoring and enforcement mechanisms, though potentially helpful, are no panacea. Given the information asymmetries from which corporate insiders inevitably benefit *especially* in countries with concentrated corporate-ownership structures and poor protection of minority shareholders' rights, and given the considerable difficulties and inherent costs of monitoring the behaviour of corporate insiders that arise therefrom, governments inevitably have a central role to play.

*Judicial vs. Regulatory Means*

For governments and policy makers the central question is of course that of the role for *public* means of corporate-governance enforcement. A further key distinction is therefore that between judiciary and regulatory means of enforcement. Particularly relevant in this regard is evidence from a comparison of recent experiences in Poland, Hungary and the Czech Republic[44]. The evidence suggests that a relatively centralised *regulatory* approach to the enforcement of securities laws – by an adequately funded, motivated and independent (yet accountable) securities commission – can be more effective than judicial enforcement.

Recent experience thus highlights the potential value for developing, transition and emerging-market economies of having a centralised, politically independent, accountable, well-funded and motivated securities commission

43. A good example is stock-market listing requirements: Many stock exchanges were created by groups of securities brokers or traders and remain privately owned and operated; while few would deny the importance for a country of having a public securities-market regulator (a "securities commission") as a separate monitoring and enforcement body, the threat of de-listing by the stock exchange can serve as a powerful enforcement mechanism in its own right. Another important case in point is that of collective self-enforcement of professional standards, and perhaps of a code of professional ethics, by members of certain key professions, such as accountants and auditors, whose enforcement depends mainly on the importance of reputational effects both within and outside the profession.

44. See also Glaeser *et al.* (2000).

which is endowed with adequate regulatory powers. True for all countries, this observation is especially true for countries with weak judiciary systems, not least because of the considerable amount of time it can take effectively to strengthen a country's judiciary system.

Policy makers should not, however, perceive the choice between regulatory and judiciary means of enforcement as an either-or choice. Each set of institutions (regulatory and judiciary) has its potential strengths and inherent weaknesses. Judicial and regulatory means of enforcement should be seen – and developed – to work as complements.

Indeed, from a long-term development perspective, few institutions are more important for sound rules-based governance than a well-functioning court system. Part of the reason is that a country's institutions of corporate governance comprise considerably more that its securities laws and their enforcement (e.g. the importance of contract enforcement). Another, crucial reason is the danger of regulatory "capture", which occurs when those people and organisations (e.g. the securities commission, other sector-specific public regulatory bodies) with responsibility to regulate corporate behaviour in a given market are corrupted or otherwise unduly influenced by one or more participants in that market[45]. The risk of regulatory capture tends to be especially great, moreover, precisely in countries with strong distributional cartels – groups whose actions are also often reflected in the very weakness of those countries' judiciary systems – as discussed earlier.

Experience shows that strengthening a country's politically independent judiciary system can therefore be one of the most important and valuable corporate-governance challenges a developing, transition or emerging-market country can undertake[46]. This importance is compounded by the fact that in countries that lack relatively strong, independent and adequately funded judiciaries, the overall risk for the economy of regulatory capture tends to be greater as well.

Developing a strong, competent, politically independent and well-funded judiciary is therefore important for enhancing the contribution of corporate governance to corporate performance.

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45. See Hellman *et al.* (2000), Kaufmann and Kraay (2002), and Kaufmann (2003).

46. See for example the chapters on Brazil and India in Oman (2003).

### *Real Sector Implications*

Significant wastage and misallocation of real human and physical capital in countries that suffer critical shortages of both widely constitute serious constraints on development, as noted earlier, as does rigidity, often combined with volatility, due to excessive resistance to needed change. These are also problems towards whose solution improved corporate governance can make a significant contribution. It can do so by helping to discipline corporate insiders – in private business groups and state-owned corporations alike – in the way they allocate and especially in the way they use, steal, or waste the sizeable real resources they control.

In the real as in the financial sector, however, the institutions of corporate governance cannot operate alone. In the financial sector, as noted earlier, policy makers must give careful attention to ensuring a sound banking system (including bankruptcy procedures, etc.) along with measures to enhance protection of minority shareholders' rights and others to strengthen corporate governance per se. In the real economy, policy-makers must simultaneously give attention to three sets of institutions:

- those of corporate governance per se;
- those of market competition;
- the regulatory institutions that are required in specific sectors (e.g. telecommunications, air transportation) often including several where major state-owned corporations have recently been privatised.

The significance of the institutions of market competition is of course that reasonably vigorous inter-firm price competition can serve as a major tool to discipline corporate insiders to allocate and use resources efficiently. The problem in many developing, transition and emerging-market countries is precisely the extent to which such price competition is overwhelmed or displaced by the actions of distributional cartels. Significant recent moves to liberalise trade and investment policies and to reduce anti-competitive market regulations help. But many countries may need to establish or strengthen a pro-active domestic *competition agency* – one with sufficient political autonomy and resources to be able to monitor compliance with and enforce the rules of healthy price competition. As in the case of corporate governance, competition policy needs greater attention from policy makers in many developing, transition and emerging-market economies[47].

47. See also Oman (1996*b*).

Similarly, it is difficult to overstate the importance for policy makers to give adequate attention to the need for *regulatory reform* and the establishment of competent regulatory bodies in those specific sectors (in addition to financial services) that require regulation[48]. This importance is considerably amplified by the risk of regulatory "capture" especially where there are strong distributional cartels[49].

For a country's competition authority and sector-specific regulatory bodies alike, a crucial challenge is to achieve the appropriate balance between the operational *independence* each needs (notably from short-term yet often intense political pressures from the government, but also from producers, consumers, financial institutions, employees and other potentially powerful market actors), on one hand, and the high degree of institutional *accountability* which each must accept, on the other. Parties to whom accountability is due may include the public executive authority that established the agency, members of the legislature that makes the agency's relevant governing legislation, and the judiciary that applies (and in common-law countries may also help make) that legislation. The parties to whom accountability is due may also include consumers, industry and other taxpayers or interested citizens – since they are among those who collectively constitute the polity in which all public regulatory authority ultimately resides.

A high degree of operational *transparency* is key to achieving this balance between independence and accountability. Such transparency contributes as well both to a country's ability to attract investors (especially "patient" investors, who generally need to be assured of a long-term commitment to relative regulatory *stability*) and to facilitate a necessary degree of regulatory *flexibility* (needed for adapting to significantly changed technological conditions for example) in the real economy[50]. Both are crucial for sustainable real productivity growth.

48. To compensate for weak or underdeveloped domestic regulatory capabilities, many governments undertaking (partial) privatisation of state-owned firms, especially in sectors judged to be natural monopolies or otherwise to have some "strategic" national importance, have retained a "golden share" in such firms to allow for continued state oversight of their management. In actual practice, however, this approach has often allowed government and/or insiders in these companies to commit serious abuses of minority shareholders and other investors. OECD (2003*a*) thus notes that determining the proper role for the state in the governance of companies deemed "strategic" (and, one might add, determining what constitutes "strategic") remains an "ongoing challenge" for policy makers in many developing, transition and emerging-market countries.

49. See also Kaufmann (2003), Kaufmann and Kraay (2002), and Hellman *et al.* (2000).

50. See Córdova-Novion and Hanlon (2002).

It is in the dynamics of inter-action among these three sets of institutions (those of corporate governance, market competition and sector-specific market regulation) that will lie the success or failure for many countries of escaping from the vicious circle referred to earlier – i.e. their ability to move away from a situation where negative-sum games of strategic rivalry within and among powerful distributional cartels too often overwhelm healthy inter-firm price competition. These countries need to move to a situation where, if the negative-sum games are not eliminated, they no longer largely trump the benefits of healthy price competition. Only by achieving this movement can they hope to achieve reasonably sustained productivity growth – the key to long-term development.

***Political Governance***

The very strength of resistance to many of the changes needed significantly to enhance corporate governance often exerts itself most strongly (even when corporate insiders give lip service to the need for better corporate governance) through clientelistic relationship-based systems of *political* governance. The relative weakening or collapse of such systems in recent years, widely visible in the greatly reduced capacity of state-controlled providers of investment finance (such as national development banks) to supply such finance, can thus be seen as a "window of opportunity" for countries to achieve change that is needed as much in the institutions of political governance as in those of corporate governance. Indeed, in all countries, negative-sum games can rarely be eliminated without close attention to the institutions of political governance.

The close interaction between the institutions of political and corporate governance is clearly reflected in at least three ways:

- in the central roles the main legislative, regulatory and judicial bodies play in the establishment and evolution of many key corporate governance institutions (cf. Annex1);
- in the extent to which distributional cartels exert their power in both the economic and political spheres of activity in a country; and
- in the importance of the enforcement issue.

It is therefore virtually impossible to move to an essentially rules-based system of governance in one of those sets of institutions without doing likewise in the other[51]. Ultimately, they are inseparable.

51. See also Kuchta-Helbling (2003) and Sullivan (2002).

Ideas on the nature of good political governance developed some three centuries ago, notably by Locke and Montesquieu, thus appear particularly relevant again today. Those views highlight the importance of establishing a clear and effective separation of powers and responsibilities among *three* branches of government – a representative legislature with oversight capabilities, a competent and accountable executive branch (including its public administration), and a fair and independent judiciary – and highlight the importance of establishing an effective system of checks and balances among the three. They constitute the principal conceptual foundations for an effective rules-based system of political governance.

Equally important – and too often violated – is the fundamental need to ensure an effective separation between private and public interests[52]. Also indispensable, in this vein, is an effective separation of powers and responsibilities between a strong corporate sector capable of generating sustained productivity growth, on the one hand, and strong rules-based institutions of political governance, including well-defined property rights, on the other[53].

As recent experience shows in the transition economies, where free markets and private enterprise are now relatively well established yet progress in the establishment of democracy remains much more uneven, political competition and the prospect of significantly enhanced international institutional integration (notably among EU accession candidates) are both important for sustaining progress in domestic institution building and transition reforms as a whole.

The bottom line is that good corporate governance requires good political governance, and vice versa. Long-term national development requires both. Policy makers need to give careful attention to the incentives and means that can be mobilised to ensure sound political governance, without which efforts to improve corporate governance may prove ineffective.

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52. See also CIPE (2002).

53. Property rights include share ownership, of course, and insecure systems of share registration which have led to de facto theft of shares (purchased by foreign and domestic investors alike) are a serious problem in some transition economies (see also OECD 2003*a*). Improper share registration can also be used by controlling insiders, in unlisted as well as listed companies, to perpetuate opaque control structures that help obscure self-dealing and abusive related-party transactions, which can only be identified (by regulators as well as by other investors) if information about a firm's transactions can be matched with information about the ultimate ownership of the parties involved. For both reasons, countries need to have independent and reliable share registries [see also CIPE (2002)].

## Conclusion

Corporate governance has a role of vital importance to play in today's developing, transition and emerging-market economies – a role that is often not fully understood. In poor countries as in middle-income countries, in countries that have few companies with widely traded shares as in countries that have many, this importance reflects the central role, today, of corporate governance in the quality of a country's institutions of governance as a whole. It reflects the importance for long-term development of moving successfully from heavily relationship-based to effectively rules-based systems of governance.

One key role for corporate governance, which is most widely understood, is to help increase the flow, and lower the cost, of the financial capital that firms need to finance their investment in real assets – human and technological as well as material. The importance of this role has grown considerably in developing, transition and emerging-market economies in recent years, and is likely to continue to grow, as the needs of companies for external finance in those countries have grown precisely at a time when the capacity of traditional sources of such finance there has greatly diminished or disappeared.

The significant growth of international portfolio equity flows especially by OECD-based institutional investors (but also of international direct investment flows[54]) points to a potential for improved corporate governance in developing, transition and emerging-market countries to contribute to the stability of international financial markets. The potential benefits of such stability are significant for recipient as well as source economies.

Less widely perceived is the potential contribution of an improved national system of corporate governance to enhancing liquidity in the country's economy as a whole. This contribution is potentially very important for many small and medium-sized, as well as large, companies – and thus for economic development in many countries.

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54. Equity investment is effectively synonymous with direct investment in the transition countries where the EBRD operates, since there continues to be very little international portfolio equity investment in these countries. But it should be emphasised that sound corporate governance can support FDI as well as portfolio equity investments, in these and other developing and emerging-market countries, because some strategic investors want majority but not necessarily complete ownership of the company in which they invest. The ability to attract portfolio equity is therefore of interest to some strategic investors as well.

Still less widely perceived yet equally if not more important are the major potential benefits of improved corporate governance for achieving long-term productivity growth in the real economy of developing, transition and emerging-market countries. Volatility combined with excessive rigidities and huge wastage of real investment resources, both human and material, result from the actions of distributional cartels in many of those countries. Those actions, reflected in ubiquitous self-dealing and rent-seeking behaviour by corporate insiders in a context of clientelistic relationship-based systems of local governance, too often constitute a serious obstacle to sustained productivity growth. Improved corporate governance has an important potential role to play in helping to limit that behaviour and thereby help to overcome a major obstacle to sustained productivity growth in many countries.

Improved corporate governance is not, however, a development panacea. In the financial sector, close attention must also be given to measures to strengthen the banking sector, and a country's financial institutions as a whole. In the real sector, close attention must also be given to competition policy and to sector-specific regulatory reform. Such attention is important for all developing, transition and emerging-market economies.

Forces working in favour of improved corporate governance include those operating both on the demand and on the supply side of portfolio equity flows to corporations. Those on the demand side include corporations whose extra-firm financial needs have grown as their traditional sources of supply have shrunk; in some cases they also include governments responsible for those traditional sources of finance. Those on the supply side include major institutional investors, especially pension funds and other long-term investors, based in OECD countries and, increasingly, in the developing, transition and emerging-market economies themselves. EBRD and OECD efforts have also, it is to be hoped, been a positive force for change.

Forces working against significantly improved corporate governance (which may nevertheless give lip service to the need for such improvement) include many dominant shareholders and other corporate insiders – operating in the private and public sectors alike – who often constitute entrenched distributional cartels. Particularly problematic is also the extent to which cross-shareholdings, multiple share-classes, and especially pyramidal corporate ownership structures are used to generate corporate-control rents.

The importance of distributional cartels in developing countries, as obstacles to development as well as to improved corporate governance, and the heightened risk of regulatory capture in countries with clientelistic relationship-based systems of governance only reinforce the fact that good corporate governance requires good political governance, and vice versa. Development requires moving from the rule of persons to the rule of law, in the institutions of corporate and political governance together.

*Annex I*

## Corporate Governance Institutions and Actors - *an indicative list*

A country's corporate-governance institutions comprise both formal and informal rules (the latter notably include a country's generally accepted business practices and ethical standards, though these are normally unwritten[55]) that are established among private actors as well as by the state or other public authorities. An indicative, hypothetical list of formal corporate-governance institutions and key actors includes:

♦ **Corporate law**, in particular legislation that *i)* gives corporations juridical personality, i.e. recognises their existence as legal "persons" separate from their shareholders; *ii)* determines corporate chartering requirements; and *iii)* limits the liability of shareholders to the value of their equity.

♦ **Securities laws** which authorise and regulate the issuing and trading of corporate equity and debt securities (including laws on the responsibilities and liabilities of both securities *issuers* and market *intermediaries* such as brokers and brokerage firms, accounting firms and investment advisers).

♦ A government body ("**securities commission**") that has the legal authority and the material and human resources to regulate the issuing and trading of corporate securities, including the means needed to *monitor* and *enforce* compliance with securities laws.

♦ **Stock-exchange listing requirements,** i.e. the conditions corporations must fulfil to be able to list and trade their shares on a given exchange (often a privately owned and managed organisation regulated by the securities commission), conditions whose fulfilment may be monitored and enforced (notably via the threat of de-listing) primarily by the exchange itself or jointly with the securities commission.

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55. Note, moreover, that when a formal institution is incompatible with or somehow contradicts one or more key informal ones (in North's words, when there is "tension" between formal and informal institutions), it is the *informal* institution(s) that tends to prevail over the formal one(s) in guiding people's behaviour (North, 1990).

♦ A **judiciary system** with sufficient political independence and the investigative as well as judicial powers and the resources required to make and enforce, without excessive delay, informed and impartial judgements.

♦ **Professional associations** or "guilds" (such as those of accountants, stockbrokers, institutes of directors) that contribute – e.g. through membership-licensing, information-sharing, peer pressure – to the definition and maintenance of standards of professional conduct in their field.

♦ **Business associations** and chambers of commerce that, in a similar fashion, use formal and informal means to influence members' thinking on and behaviour with respect to acceptable business practices;

♦ Other private and public **monitors** of corporate and securities-market participants' behaviour (notably *pension funds* and other *institutional investors, ratings agencies, financial media*).

In addition to these corporate-governance institutions and actors (including the body or bodies that enact relevant legislation), two broad categories of laws, regulations, other formal and informal rules and generally accepted practices are important: those that concern corporate *oversight* and *control;* and those that concern information *disclosure* and corporate *transparency*.

***Oversight*** **and** ***Control***

♦ **Shareholder voting** rights and procedures (including those that are especially important for the protection of *minority* shareholder rights *vis-à-vis* dominant shareholders as well as *vis-à-vis* management, such as *cumulative* voting rights and other so-called anti-director rights[56]).

♦ The **duties, powers** and **liabilities of corporate directors** (boards and individual directors, including definition of what constitutes an "independent" director and requirements on board composition and on the constitution of board committees on audit, the nomination of directors and the remuneration of directors and top executives).

56. "Anti–director rights" is the expression used by La Porta *et al*. (1998*b*) to refer to six key shareholders' rights: the right to *mail* their proxy vote to the firm; to participate in the General Shareholders' Meeting without having previously deposited their shares with the company; to benefit from cumulative voting or proportional representation of minorities on the board of directors; to benefit from the existence of an oppressed minorities mechanism; to hold an Extraordinary Shareholders' Meeting if it is called for by a minimum of no more than 10 per cent of share capital; and to pre-emptive rights to new issues that can only be waived by a shareholders' vote.

♦ **Proscription of self-dealing** by corporate insiders (whether self-dealing occurs via related-party transactions[57], or "tunnelling"[58] or takes the form of insider trading[59]).

♦ **Stock-tendering requirements** (notably to protect small shareholders in the context of a corporate merger, acquisition or privatisation)[60].

♦ **Judicial recourse** for shareholders *vis-à-vis* managers and directors (derivative suits, class-action suits[61]).

♦ The functioning of **markets for corporate control** (take-over markets)[62].

♦ The functioning of **markets for professional managers**, and of **labour markets**.

***Disclosure*** and ***Transparency***

♦ **Financial accounting standards**, and how those standards are set.

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57. "Related-party transactions" are business transactions between a corporation and one or more other firms, or one or more individuals outside the corporation, with which (whom) one or more corporate insiders have a personal (often family) relationship. Related-party transactions are widely used as a vehicle for self-dealing (see note 18) although not all related-party transactions involve self-dealing.

58. "Tunnelling" is self-dealing that occurs within pyramidal ownership structures when controlling shareholders' transfer resources from companies in which they have smaller cash-flow rights (cf. note 13) to companies in which they have larger cash-flow rights; it is analogous to asset-stripping. See Johnson *et al.* (2000).

59. Insider trading occurs when corporate insiders or others with privileged access to information likely significantly to affect the market value of a company's shares use that information to make profits through trading in the company's shares before the information is released to other market participants.

60. Particularly important are pre-emptive rights to new issues – sometimes referred to in Brazil as "tag along" rights – included among the "anti–director rights" cited in note 56.

61. Derivative suits allow shareholders to sue corporate directors on behalf of the corporation itself; class-action suits allow individuals to sue on behalf of an entire class of individuals (e.g. shareholders in a given company).

62. See also Leechor (1999).

♦ Public **disclosure,** in a clear and timely manner, of such information as financial accounts (including both *segment* and *consolidated* accounts, the level and means of remuneration of directors and top executives); related-party transactions undertaken by corporate insiders; compliance, or the reasons for non-compliance, with specific provisions in corporate-governance codes, other relevant codes, laws, regulations and self-declared corporate values or objectives.

♦ **External audit** (including how the auditor is chosen).

♦ Independent or **"third-party" analysis** and assessment of corporate prospects (e.g. by stockbrokers, risk-assessment specialists).

*Annex 2*

## EBRD Guidelines on Sound Business Standards and Corporate Practices

The purpose of the Guidelines is to help companies in transition economies achieve long-term success. Such success depends not only on a company's having a sound strategy, competent management, valuable assets and a promising market. It also depends on the company's maintaining a sound relationship with the six main constituency groups on which it depends: customers, shareholders, employees, suppliers, the community in which it operates, and government and local authorities. The Guidelines articulate a set of general standards for each of these six relationships, and for a proper set of checks and balances based on the principles of disclosure, management accountability, separation of responsibilities and sound internal controls.

The Guidelines are designed for companies in economies where legal and fiscal systems are in a state of flux, and where a consensus may not yet exist – or may differ considerably from one country to another, or change rapidly even within a country – on the business standards that are immediately achievable. The Guidelines are designed to be generally applicable but must of course be elaborated on a country-by-country and company-by-company basis to take into account applicable laws, regulations and other specific circumstances (such as company size). The Guidelines seek to help companies to understand clearly the kinds of standards for which they should aim, and the importance of their being committed to achieving those standards.

See: http://www.ebrd.com/pubs/index.htm click "Sound Business Standards".

## OECD Principles of Corporate Governance

The OECD agreed its Principles in 1999 on the basis of a consensus among all OECD member governments and after extensive dialogue with a wide range of stakeholders. The Principles focus on five core issues: shareholders' rights; the

equitable treatment of shareholders, especially minority shareholders; the role of stakeholders, notably including employees; information disclosure and transparency; and the responsibilities of corporate directors and boards.

The Financial Stability Forum uses the Principles as one of its 12 core standards, and consequently the IMF and the World Bank use them as part of the review of standards and codes (ROSC). The Emerging Markets Committee of the International Organisation for Governmental Securities Commissions (IOSCO) has also endorsed the Principles.

The Principles have provided a conceptual framework for five Regional Corporate Governance Roundtables jointly organised with the World Bank Group comprising national policy makers, regulators and market participants in Asia, Russia, Latin America, Eurasia and South East Europe. With the exception of Eurasia, each Roundtable has produced a White Paper setting out policy priorities, as summarised in OECD (2003*a*). The Roundtables have supported significant legal and institutional change in a number of countries, a process that will continue as the White Papers are more widely disseminated and the participants strive to implement the key policy recommendations.

The Principles are now being reviewed by OECD governments in consultation with civil society and non-member countries.

See: http://www.oecd.org/DAF/corporate-affairs/

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