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by

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TABLE OF CONTENTS

PREFACE 5

RÉSUMÉ 10

ABSTRACT 11

I. INTRODUCTION 12

II. THE CONCEPT 13

III. WHY CORPORATE GOVERNANCE MATTERS FOR DEVELOPMENT 14

IV. FACTORS OR FORCES WORKING FOR AND AGAINST IMPROVED CORPORATE GOVERNANCE IN DEVELOPING COUNTRIES 19

V. POLICY IMPLICATIONS 22

VI. POLITICAL GOVERNANCE 29

VII. CONCLUSION 30

ANNEX 1 INSTITUTIONS OF CORPORATE GOVERNANCE 35

ANNEX 2 LIST OF PARTICIPANTS 38

OTHER TITLES IN THE SERIES/AUTRES TITRES DANS LA SÉRIE 43

PREFACE

The OECD *Principles of Corporate Governance* establish a common set of key reference points. They also provide a common language for discussion and common criteria for implementation. In this regard, the *Regional Corporate Governance Roundtables* organised by the OECD and the World Bank serve as a forum for on–going and structured policy dialogue around the OECD *Principles*.

For its part, the OECD Development Centre and the European Bank for Reconstruction and Development organised an informal policy dialogue on *Corporate Governance in Developing Countries, Emerging Markets and Transition Economies* on 23–24 April 2001. This paper is based on a transcript of the author's remarks kindly supplied by the Center for International Private Enterprise, a Washington think tank that co–sponsored the event.

Seven country case studies commissioned for the Development Centre and research undertaken by the EBRD constituted the platform for discussion. The case studies cover the four members of the Development Centre that are not Members of the OECD (Argentina, Brazil, Chile and India) and two countries with which the Centre has a long–standing relationship (China and South Africa). Malaysia was thought to be a useful additional case study, given its high stock–market capitalisation and its specific response to the Asian financial crises. Invited experts provided perspectives from Russia, and from Kenya, Senegal and Zimbabwe. The overall experience of the EBRD with corporate governance and the rule of law, especially the work of Joel Hellman (now at the World Bank), Katharina Pistor (Harvard University) and their co–authors, was reviewed in the last session.

The case studies identified key forces resisting moves to improve corporate governance, including vested interest goups, and those that can be mobilised to work for improvements such as the rise of institutional investors. Two of their titles, "Private Vices in Public Places" and "The Tide Rises, Gradually", convey the tenor of the studies and also of this paper. They are listed in the references and available on our website. In the paper they are quoted by the name of the country.

While the case studies emphasised larger corporations, listed on the national stock market, the positive effects of improved governance apply to small and medium sized enterprises as well. The main messages from the discussion during the 23–24 April 2001 policy dialogue meeting are two. First, greater attention to corporate governance during the development process helps the country concerned earn policy credibility abroad, while signalling a commitment to transparency at home. Second, there is no "one size fits all" in corporate governance because of the interaction with the regulatory framework on the one hand and political governance on the other. The specifics of the "rule of law" are, of course, relevant in both of these interactions.

Clearly the further the institutions of corporate governance are from the hypothetical list in Annex 1, the greater the need for institutional change. Even if the institutions exist on paper, the way in which they function and interact with the regulatory framework and political governance remains decisive. This is why the development perspective adopted here remains general, rather than exclusively geared to the seven case studies.

The April 2001 dialogue was highly interactive. It involved institutional investors, regulators, academics and representatives of the OECD's Economics Department, Directorate for Financial, Fiscal and Enterprise Affairs, and Centre for Co–operation with Non–Member Countries — the last of which also co–sponsored the event. The lists of participants in the policy dialogue, and in the informal workshop held in 2000 to discuss first drafts of the case studies, are included in Annex 2 below. In addition delegates from Argentina, Austria, Belgium, Brazil, Chile, France, Germany, Greece, Japan, Korea, Mexico, Portugal, South Africa, Spain and Switzerland attended the informal policy dialogue.

* * *

It was after the Development Centre's *Washington Conference on Corruption*, coinciding with the signing of the *OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions,* in February 1999, that we began to look at corporate governance from a developmental perspective. This was a natural sequel to the *Washington Conference*, which had shown the important role of the private sector in the quest for more transparency and the fight against corruption. Its final report was issued in October 2000 on the occasion of an *Anti–Corruption Summit* organised in Washington among others by USAID and the World Bank.

Meanwhile, our scope of inquiry was broadened in the 2001–2002 programme of work by looking at how transparency and corporate governance interact with democracy and regulatory reform. This broadening of scope is essential to capture the evolving challenge in the process of development from aid–dependent situations, to emerging markets, to OECD–type societies. It is also consistent with the overall theme of the Centre's programme of work since 2000, *Globalisation and Governance* (G&G). A panel on G&G at the *OECD Global Forum 2001* revealed the interest of this particular developmental approach for the Organisation and its Member countries.

The reason for such wide interest is, of course, that in conjunction with globalisation many developing countries have embraced democratic governance. Even in countries that do not yet have free elections, civil society is pressing for information and a voice in decisions about public policy, with more open discussion. In all kinds of political systems, issues of transparency and accountability have moved to the centre of the public agenda.

The Centre's current work on "Empowering people to take advantage of globalisation" thus seeks to identify the economic pillar of democratic governance in developing countries, probing into the politics of credibility. At a meeting of the *Initiative for Policy Dialogue* convened by Joseph Stiglitz and Ann Florini at the Carnegie Endowment for International Peace, Washington, D.C., on 9 February, 2001, I also showed how our corporate governance and anti–corruption work feeds into political governance. This activity is to be co–ordinated with the OECD's Directorate for Financial, Fiscal and Enterprise Affairs and its Public Management Service. In fact, it was at the High–level Seminar of the OECD *Governance Outreach Initiative* on "Partnerships in Governance: Common Responses to the Challenges of Globalisation" held in Paris on 9–10 May 2000, that I first had an opportunity to emphasise the link between corporate and political governance.

As the informal policy dialogue on *Corporate Governance in Developing Countries, Emerging Markets and Transition Economies* revealed, and this paper highlights, private–sector standards and initiatives to improve corporate governance, along with government–established rules and legislative initiatives at the national, regional or international level, continue to have great potential. The developmental perspective builds on this potential and adapts it to diverse social and cultural environments. The conclusion is inescapable: reaping the full benefits of globalisation, for all countries and for all segments of the population, including the poor, requires good political governance. Good political governance encompasses good corporate governance *and* good regulatory reform. Both need good political governance; both can contribute to it.

Moreover, the relationship between achieving better corporate governance and regulatory reform is one of mutual influence, and both must reflect a country's overriding political values. Accountability, and checks and balances, are needed for all members of society to share in the benefits of globalisation through the combination of political freedom and financial freedom. Markets can be myopic. So can democratic governments. For example, regulators must be protected as much from the pressure of politics and politicians as from the threat of "capture" by powerful corporations and other "market" actors.

Corporations are often more sensitive than voters to the need for long–term vision and foresight — not least because of the very nature of the production process. In contrast, financial–market "herdism", which pushes non–financial corporations towards a short–term mentality, affects the corporate governance of financial institutions. This is why strong financial systems are key, even though little is known about the political economy of local bank supervision and bankruptcy laws and procedures, or of protecting non–controlling shareholders' rights.

Good corporate governance requires strong protection of minority rights. The rights of investors are understood to be more inclusive than shareholder rights alone (as long as the financial or even human or other non–financial investment is firm–specific). "Asset–stripping", in both visible and invisible forms, is pervasive in developing countries. It may initially rise during the process of market emergence.

Given pervasive "asset–stripping", the fight against corruption goes well beyond failures of corporate governance and has expanded to areas such as political parties and the role of the media in fighting corruption. Yet the private sector needs to take this matter into its own hands without being prompted to do so by the the government. It is in the private sector's interest to operate in an environment of workable competition where the rule of law prevails. Not only is corruption bad for business, *business is bad for corruption*. Yet conventional wisdom continues to associate corruption with private enterprise, not state intervention. Conversely, anti–corruption continues to be seen as a matter for the state rather than a concern for business.

In addition, the information revolution creates new politics of credibility in which financial freedom is an essential ingredient of transparency. As I have argued elsewhere, based on the experience of Argentina, a link can be seen between transparency and democracy, which could be captured by a kind of transition between the concerns of the NGOs *Amnesty* and *Transparency International.* When citizens enjoy both political and financial freedom, they are more likely to mobilize against practices of mismanagement and corruption. The Argentine case confirms that establishing democratic institutions and freedom of speech is necessary but not sufficient. Decisions taken in the economic sphere such as liberalisation of trade, and reform of the exchange–rate system, are also needed to transform the situation and get a country on a virtuous path.

* * *

Stating that the case studies in this project point to the relevance of improved governance in the process of development is one thing, rationalising the move beyond democracy to transparency via financial freedom in Argentina is another. Both are certainly suggestive of the G&G interaction in specific national circumstances. Yet a positive causal effect of globalisation on governance — as measured by apparent corruption — is precisely the result of econometric research conducted at the OECD Development Centre, published as Technical Paper No. 181. From a cross–section of 119 countries over the periods 1984–88 and 1990–98, Federico Bonaglia, Maurizio Bussolo and I found that the effect of import openness on corruption is one third that of income per capita. The effect of import openness on the index of apparent corruption is supposed to reflect good governance and the effect of the level of income and of corruption is controlled by using instrumental variables related to physical remoteness and cultural characteristics. Those results extend to financial openness and are robust to the introduction of cultural variables, including "OECD membership". They confirm that globalisation could be included as one of the forces working to improve governance, alongside the rise of international portfolio investments by institutional investors based mostly in the United States and in Britain mentioned in this paper.

In addition to the author of this paper and to the authors of the country case studies, I would like to thank Deputy Secretary–General Seichii Kondo for opening the policy dialogue and Sally Shelton–Colby for inviting me to the May 2000 *Governance Outreach Initiative*.

I am grateful to the Alfred P. Sloan Foundation for its grant in support of the country case studies and the 2000 workshop. The Center for International Private Enterprise, The Asia Foundation, the Club du Sahel's Private Sector Support Programme and the OECD Centre for Co–operation with Non–members also deserve our gratitude for making possible what was unanimously looked upon as a memorable informal dialogue between diverse but not mutually exclusive perspectives on development.

Jorge Braga de Macedo
President
OECD Development Centre

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RÉSUMÉ

La gouvernance des entreprises est un élément clé de développement national. D'après une série d'études de cas (Afrique du Sud, Argentine, Brésil, Chili, Chine, Inde et Malaisie), elle joue un rôle de plus en plus important dans l'accroissement des flux de capitaux destinés à financer les entreprises des pays en développement. Tout aussi importants sont les bénéfices potentiels d'une meilleure gouvernance des entreprises pour surmonter les obstacles (notamment les actions des groupes d'intérêts cartélisés) à une croissance durable de la productivité dans l'économie « réelle ». L'amélioration de la gouvernance des entreprises ne peut cependant pas être considérée hors de son contexte. Du côté du secteur financier, il faut s'attacher également au renforcement du secteur bancaire et des institutions financières nationales dans leur ensemble. Du côté du secteur réel, la politique de la concurrence et les réformes réglementaires sectorielles doivent faire l'objet d'une attention soutenue.

Parmi les forces qui oeuvrent en faveur d'une amélioration de la gouvernance des entreprises dans les pays en développement, certaines agissent sur la demande et d'autres sur l'offre de flux de portefeuille, tant nationaux qu'internationaux, à destination des entreprises de ces pays. Quant aux forces qui resistent à une amélioration notable de la gouvernance des entreprises (en dépit parfois d'un soutien de façade à ces améliorations nécessaires), elles comptent des grandes actionnaires ainsi que d'autres acteurs ayant le contrôle effectif des entreprises — tant dans le secteur public que privé — liés dans des cartels. Le risque élevé d'appropriation des dispositions réglementaires à des fins privées dans les systèmes de gouvernance fondés sur des relations clientélistes (par opposition aux systèmes fondés sur des règles établis) confirme qu'une bonne gouvernance des entreprises requiert une bonne gouvernance politique et inversement.

ABSTRACT

Corporate governance matters for national development. Case studies of Argentina, Brazil, Chile, China, India, Malaysia and South Africa suggest that it has a role of growing importance to play in helping to increase the flow of financial capital to firms in developing countries. Equally important are the potential benefits of improved corporate governance for overcoming barriers, including the actions of vested interest groups, to achieving sustained productivity growth. Improved corporate governance, however, cannot be considered in isolation. In the financial sector, 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 be given to competition policy and sector–specific regulatory reform.

Forces working in favour of improved corporate governance in developing countries include those operating both on the demand and on the supply side of domestic and international portfolio equity flows to corporations in those countries. Forces working against significantly improved corporate governance (which may nonetheless give lip service to the need for such improvement) include many dominant shareholders and other corporate insiders — in the private and public sectors — in entrenched distributional cartels. The heightened risk of regulatory capture in countries with clientelistic relationship–based (as opposed to rules–based) systems of governance reinforces the fact that good corporate governance requires good political governance, and vice–versa.

I. INTRODUCTION

From the perspective of national development, corporate governance was long ignored. It was practically invisible until the East Asian financial crisis of 1997–1998 drew attention to it and to the problems of "crony capitalism" in emerging–market economies. As the threat to global financial markets raised by that crisis is seen to recede, the risk is that efforts significantly to improve corporate governance in the developing world will flag.

That would be a mistake. It would be a mistake because, as this paper will argue, the institutions of corporate governance play an essential role in the long–term process of development of a country. True in the past, this importance of corporate governance for development becomes all the greater as the current wave of globalisation advances.

The paper draws heavily on the findings of the seven country case studies undertaken for the Centre's research on corporate governance. It focuses on drawing lessons from the significant relative *commonalities* among the challenges faced by the countries studied — Argentina, Brazil, Chile, China, India, Malaysia and South Africa — notwithstanding the great diversity among them. It is organised into five sections, aside from this introduction and a conclusion. Section II defines corporate governance and Section III shows why it is important for development. The key factors or forces that tend today to work *for* improved corporate governance in the developing world, or that can be mobilised to do so, and the forces working *against* such improvement are dealt with in Section IV. The policy implications, especially the concrete steps that should be taken in the financial sector so as to improve corporate governance, are in Section V. Before concluding, a brief mention of political governance is found in Section VI.

II. THE CONCEPT

Defined broadly, "corporate governance" refers to the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs ("corporate insiders") on one hand, and those who invest resources in corporations, on the other. Investors can 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.

Specifically, what are the institutions of corporate governance? Not only do they vary from country to country — in form and substance and, importantly, in how they mutually interact in a given country — they evolve over time. An indicative, hypothetical, list can nevertheless illustrate the main institutions of corporate governance. Comprising key "actors" and relevant legislation, regulations, other formal and informal rules, and generally accepted business practices, that list is presented in Annex 1. It distinguishes between key institutions of *information disclosure* and corporate *transparency* on one hand and those for corporate *oversight* and *control* on the other.

Perhaps most important to understanding the concept, however, is to understand the *purpose* of corporate governance. In all countries, the institutions of corporate governance serve two indispensable and ultimately indissociable objectives: enhance the *performance* and ensure the *conformance* of corporations[1]. They facilitate and stimulate the *performance* of corporations — the principal generators of economic wealth and growth in society — by creating and maintaining a business environment that motivates managers and entrepreneurs to maximise firms' operational efficiency, returns on investment and long–term productivity growth. They ensure corporate *conformance* with investors' and society's interests and expectations by limiting the abuse of power, the siphoning–off of assets, the moral hazard and the significant *wastage* of corporate–controlled resources (so–called "agency problems") that the self–serving behaviour of managers and other corporate insiders can be *expected* to impose on investors and society in their absence[2]. Simultaneously, they establish the means to monitor managers' behaviour to ensure corporate accountability and provide for the cost–effective protection of investors' and society's interests *vis–à–vis* corporate insiders. They can be understood, in sum, as serving both to determine what society considers to be acceptable standards of corporate behaviour, and to ensure that corporations comply with those standards.

III. WHY CORPORATE GOVERNANCE MATTERS FOR DEVELOPMENT

A good illustration of the importance of this question, and of its challenging nature, is the fact that for 30 years or more, until mid–1997, developing East and Southeast Asia achieved very impressive, sustained, high rates of growth — growth that significantly raised their populations' standards of living — in a context that most people would now describe as one of poor corporate governance. How was that possible? If corporate governance has an important role to play in the process of development in a country, one must be able to explain the apparent paradox that the Asian growth "miracle" occurred in conjunction with poor corporate governance.

III.1 The Importance of Productivity Growth

Part of the explanation was suggested, albeit in highly provocative and caricaturised fashion, by Paul Krugman in his notorious 1994 *Foreign Affairs* article (three years before the onset of the crisis) when he compared the success of growth in East and Southeast Asia to the Soviet model, and predicted a similar outcome[3]. His point was that experience (in this case Soviet experience) shows that it is not impossible for a country to achieve and sustain high rates of output and income growth for long periods of time — many decades even — by engaging in a process of massive mobilisation of factors of production. Such factor mobilisation can be achieved through various kinds of forced saving, significant and sustained investment in the education of the country's population, high rates of rural–urban migration, mobilisation of the female population into the modern manufacturing as well as the agricultural and services sectors, and so on. It should perhaps be emphasized more clearly than Krugman did, there is nothing illegitimate about the output and income growth that stems from such factor mobilisation; on the contrary, it is rarely easy to accomplish, and it is very real.

The further point, however, is that because decreasing returns to continued factor mobilisation must ultimately set in, growth based on factor mobilisation alone cannot be sustained indefinitely. It can last for years and should not be seen as anything less than a vitally important source of economic growth, but the key to achieving sustainable development in the long run is *productivity* growth.

III.2 Relationship–based vs. Rules–based Regimes

To the importance for development of productivity growth can be added another important observation. It is that a predominantly clientelistic *relationship*–based system of corporate and political governance and poor corporate governance are quite compatible with a national development strategy based on massive factor mobilisation. Clientelistic relationship–based governance systems and poor corporate governance — ubiquitous in the developing world (including East and Southeast Asia at the time of the crisis) — appear rather less amenable to the move from a strategy of massive factor mobilisation to sustained productivity growth.

The country studies illustrate this observation well. All seven countries are in the midst of a *dual* transition, from predominantly relationship–based to more rules–based systems in their economic *and* political spheres of governance. In the economic sphere the movement is from relatively closed or inward–oriented and market–unfriendly to much more open and market–friendly systems. In the political sphere the transition is from relatively undemocratic to much more democratic systems.

Some countries are of course more advanced in their transition processes than others. Chile, for example, is more advanced than many in its move to rules–based governance in both the economic and political spheres, though its move in the political sphere is recent. Argentina and Brazil have both made very significant moves in both spheres, roughly simultaneously, since the debt crisis of the 1980s. India has long been a political democracy but in most respects effectively began its move to a more open and market–friendly economy in 1991. China began its economic transition in the late 1970s but is not yet a political democracy. Malaysia emerged from its colonial status in the 1960s as a political democracy, and soon moved to relatively outward–oriented and market–friendly economic governance, yet questions have risen in recent years about the depth of its rules–based system of political governance. South Africa began its challenging move from inward–oriented economic and undemocratic political governance to more open and democratic economic and political governance with the abolition of apartheid in the early 1990s.

Despite their major obvious differences — in regional location, in culture and history (including legal heritage), in economic and political institutions — all these countries are thus in the midst of a dual, often difficult, transition to more rules–based systems. Under *relationship*–based governance, long–term extra–firm investment finance was widely provided by state–directed, sometimes state–owned, sources such as national development banks. Many achieved significant growth of output through sustained factor mobilisation (including forced saving). But, as the Malaysian study and productivity data from the other countries attest, sustained productivity growth in the corporate sector remained out of reach. The weakening or relative collapse of clientelistic relationship–based systems and the moves underway to more rules–based systems may or may not be irreversible. They constitue an important opportunity for needed change in governance structures.

III.3 Agency and Expropriation Costs

Much of the literature on corporate governance focuses on the "principal–agent" relationship between shareholders (the principals) and managers (the agents) that stems from the separation of ownership and management in the "publicly" owned corporation of the kind that prevails in the United States and the United Kingdom, in which no single shareholder owns more than a small fraction of a corporation's stock. Many authors argue, or assume, that the *raison d'être* of corporate governance, in any country, is to protect the interests of shareholders because the interests of other investors can adequately 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[4]. They thus tend to see the role of corporate governance in development as one of helping to ensure the supply and lower the cost of the financial resources that corporations in developing countries require from extra–firm sources to finance their investment activity.

Of course, in countries where poor contract enforcement due to pervasive clientelism and/or a weak judicial system renders the very distinction between "residual" and "non–residual" claimants questionable, as is the case in many developing and emerging–market economies, the applicability of this reasoning is doubtful. Even authors who subscribe to its logic tend for example to argue that weak bankruptcy procedures create a need for corporate governance to include protection of creditors' interests in most developing countries.

More important however is the fact that, outside the United States and the United Kingdom, the corporation with widely dispersed ownership is not the rule but the exception. Such is the case in the seven countries covered in the Centre's research project, and apparently in much of the rest of the world as well[5]. What prevails are corporations with concentrated ownership, i.e. large stockholders ("blockholders") who directly control managers. Also widespread are cross–shareholdings among companies, the issuance of multiple classes of shares with different voting rights and especially pyramidal corporate ownership structures[6], all of which help dominant shareholders to control corporate assets considerably greater, even, than their direct stock ownership rights would justify[7]. The key potential conflict of interest in our seven countries — as in most non–OECD countries, and many OECD countries other than the United States and the United Kingdom — therefore tends not to be between managers and shareholders *per se* but between dominant owner–managers on one hand and minority shareholders and other investors (domestic and foreign) on the other. This conflict of interest is commonly referred to as the "expropriation problem", as opposed to the "agency problem" that applies to the principal–agent relationship between shareholders and managers.

III.4 Vested Interests

The seven countries in this project also tend to suffer from the destructive, often highly negative–sum–game, behaviour of powerful vested interests entrenched in highly concentrated oligopolistic structures of local economic and political power. That behaviour tends greatly to weaken or undermine healthy price competition and the proper functioning of markets — indispensable for the move to sustained productivity growth — as well as to weaken or undermine the development and consolidation of democratic political institutions. While the significant moves in those economies in recent years — a sea change for many — to privatise state–owned corporations, reduce anti–competitive market regulations, liberalise trade and investment policies and seek actively to attract foreign investors should have a major positive impact, they may not prove sufficient to sustain the kind of dynamic and interactive processes of productivity growth and political reforms that are needed to carry forward the fights against poverty and corruption and for the strengthening of political democracy and modernisation of the state. For developing economies even more than for the OECD zone, 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.

Indeed, in any market–based economy — developed or developing, national or global — the firm, or corporation, is 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 inducing corporations collectively to behave in ways that are good for society as a whole. There is, in other words, a principal–agent relationship between society (the principal) and corporations as a group (the agents) embodied in the institutions of corporate governance. Society provides corporations with the incentive to act (notably the right to earn profits) and the means to do so (the right to exist, and act, as "legal persons", and to benefit from limited liability) and seeks, through the institutions of corporate governance, along with those of market competition (Adam Smith's "invisible hand") and government regulation, to ensure that corporations collectively serve its best interests[8].

Today, moreover, as globalisation enhances the strength of market forces relative to that of regulation by national and subnational governments, corporate governance becomes relatively more important. In the developing world, in addition to the effects of globalisation *per se*, this importance is further amplified (positively) by the sea change towards market–friendly policy regimes. It is also amplified (negatively) by the pervasiveness of concentrated oligopolistic local power structures that are highly conducive to *self–dealing*[9] by corporate insiders, in the private and public sector alike, and to other negative–sum–game rent–seeking behaviour in those countries. Such behaviour tends to result in huge wastages of corporate–controlled resources and a highly inefficient economy–wide use of capital, as well as to perpetuate or exacerbate local inequalities, and thus to constitute a serious hindrance to long–term development in low– and medium–income developing economies alike.

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 thus significant, equally if not more important is the potential contribution of improved corporate governance to reducing the considerable waste and misallocation of *real* investment resources that constitute a major constraint on sustained productivity growth — and sustained national development — throughout the developing world.

IV. FACTORS OR FORCES WORKING FOR AND AGAINST IMPROVED CORPORATE GOVERNANCE IN DEVELOPING COUNTRIES

IV.1 Factors and Forces Working for Improved Corporate Governance

In OECD countries, interest in corporate governance has grown rapidly in conjunction with the current wave of globalisation. In the United States, the interest mushroomed in the 1980s when major US corporations suffered a number of widely publicised losses of home–market shares to foreign competitors, followed by the advent of “junk bonds” which led to the first big wave of hostile take–overs. More recent in Europe, the interest has been fuelled by deepening regional integration and the growth of cross–border mergers and acquisitions. Also important in OECD countries 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, along with concerns by corporate investors about establishing a “level playing field” for their international investment activity.

The rapid growth of international portfolio investments by OECD–based (particularly US and UK) institutional investors is in turn reflected in, and largely responsible for, the significant growth of foreign portfolio investment in “emerging market” economies in the 1990s. Portfolio *equity* investment flows going to developing countries rose from insignificant levels prior to the late 1980s to an annual average of $2.7 billion in 1989–1990 and then surged to an annual average of some $43 billion during the years 1993–1996. Dropping to about $16 billion in 1998 in conjunction with the East Asian crisis, they are estimated to have risen again to about $48 billion in 2000[10]. Foreign portfolio investors, in particular the major institutional investors, have thus been an important force working in favour of improved corporate governance worldwide.

Also important has been the establishment and growth of domestic pension funds. In Latin America, 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 of similar systems in Argentina and Brazil — and Bolivia, Colombia, El Salvador, Mexico, Peru and Uruguay[11]. While these funds and pension funds elsewhere, notably in Asia, remain small compared to OECD–based pension finds, they have been important purchasers of corporate equity issues in several of the countries covered in our study, notably in conjunction with moves to privatise state–owned corporations, and constitute another important potential force for better corporate governance[12].

If foreign and, in some counties, domestic institutional investors (pension funds in particular) have become an important force for improved corporate governance as potential *suppliers* of funds through their purchases of corporate shares in developing countries, equally important is the fact that many domestic corporations have increased their *demand* for such funds in recent years. One reason for this demand growth is the considerable increase in the needs of corporations in those countries (as elsewhere)

for extra–firm sources of capital to finance the growth of investments in tangible and intangible assets they they must undertake in order to compete in the context of accelerated change — in technology but also in the dominant business model[13] — that characterises globalisation today. The recent liberalisation of trade and investment policies and significant market deregulation or opening of domestic markets, and significant privatisation of state–owned enterprises, have all added significantly to these competitive pressures on firms in many of those countries as well.

A further reason, alluded to earlier, why the extra–firm financial needs of corporations in many of those counties has increased is that the bulk of those needs is no longer being supplied, as it was until recently, by the national development banks and other largely state–controlled sources of investment finance — sources that widely obtained those funds through various means of forced domestic savings. Virtually all the countries covered in this project, and many other developing economies, have witnessed the relative collapse in recent years of the relationship–based financial system of which those state–directed sources of finance were an integral part, greatly reducing their ability to supply long–term finance to local corporations (often in the name of "industrial policy") as they did until recently[14].

The combined result is 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, as elsewhere, have risen substantially. The result is thus also 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.

IV.2 Obstacles to Improved Corporate Governance

There is also, however, considerable *resistance* to changes needed significantly to improve corporate governance. Particularly important in this regard are the actions of the oligopolistic coalitions and powerful vested interest groups, mentioned earlier, who operate simultaneously in the marketplace, notably as corporate insiders, and in the sphere of domestic politics. They are sometimes referred to as "distributional cartels" because, in seeking to maintain or increase their share of a country's wealth (e.g. market share), they often invest significant corporate–controlled (as well as government–controlled) resources not in the creation of new wealth but in actions of strategic rivalry among themselves. Those actions tend to result not in healthy inter–firm price competition but in significant wastage and misallocation of a country's resources. They tend often to *reduce* aggregate wealth and thus constitute, from society's point of view, highly negative–sum games[15].

Distributional cartels undertake actions that not only hinder healthy inter–firm price competition and often reduce aggregate wealth, but also help to resolve certain apparent "paradoxes" of the development process. A good example is the extent to which corporations undertake large investments in highly capital–intensive production facilities that remain unused or significantly under–used (i.e. large investments in overcapacity) in countries that not only have significant supplies of unemployed or under–employed workers (i.e. surplus labour) but, virtually by definition, suffer from capital scarcity. Such "distortions" — and huge wastage of capital from an economy–wide perspective — reflect behaviour typical of distributional cartels.

Another example is the tendency of distributional cartels both to *resist* needed change — firms' need to adapt to new conditions created by the availability of a new technology or of a more effective business model, for example, or by changing consumer preferences — and, *simultaneously*, to *create* excessive *volatility* and instability in markets, and often in politics as well (volatility that can even lead, in more extreme cases, to armed conflict). The reason for this behaviour, put simply, is that, in their games of strategic oligopolistic rivalry, distributional cartels tend both to resist inter–firm price competition and any (needed) change that might upset the balance of power within their oligopoly, and to provoke (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. market share) *vis–à–vis* other members of the cartel[16].

The result is significant wastage of capital resources, both material and human, and a building–up over time of more and more bureaucracy and resistance to change in corporations and government alike, combined with relative instability or volatility and thus fragility in both the economy and local political institutions. The result is also a tendency to reproduce clientelistic relationship–based forms of both economic (including corporate) and political governance. The result is thus also to constitute a tremendous drag on growth and development, as well of course as on the changes needed to improve corporate governance.

Clientelistic relationship–based systems of governance are also, in turn, particularly fertile breeding grounds for distributional cartels. Indeed, while such oligopolies operate in all countries, it is arguably the greater *pervasiveness* of their rent–seeking and negative–sum–game behaviour — to a point where it tends to overwhelm the benefits of healthy price competition — that constitutes the greatest obstacle to sustained productivity growth in many developing countries.

V. POLICY IMPLICATIONS

V.1 In the Financial Sector

The considerable growth in the needs of corporations for extra–firm finance, due to the combined effects of accelerated global change and significant domestic policy liberalisation precisely at a time when the availability of long–term investment funds from traditional sources (e.g. national development banks) has declined markedly, means that the institutions of corporate governance have a significant potential role to play in helping to channel investment finance to firms. While this role can be described as one of factor mobilisation, it has become more important in recent years, as reflected in the spectacular increase in the extent to which firms in "emerging markets" have turned to domestic and especially foreign portfolio investors as suppliers of funds.

V.1.2 Stock Markets

Understood by many as the *raison d'être* of corporate governance, the increased importance of improved corporate governance is reflected in the spectacular growth in the size of the stock market — i.e. in the value of shares listed, referred to as "market capitalisation" — in all the case studies. South Africa and Malaysia, for example, have seen their market capitalisation rise in 1999 to over 150 per cent of GDP (as it did in Singapore, Hong Kong and Chinese Taipei, not covered in our project). Recently, however, several, including Argentina, Brazil and South Africa, have also witnessed a serious *weakening* or shrinking of activity on their local stock markets due to one or more of three phenomena. Many major local firms have seen their shares de–listed after they were bought by foreign corporations (i.e. taken over through foreign direct investment). Many others have turned to, or increased their use of, American or Global Depository Receipts (ADRs/GDRs) to sell shares in New York or London[17]. A few, most notably in South Africa, have simply moved their listing from the local market to London or New York[18].

While a weakening of stock–market activity is not necessarily indicative of weaker corporate governance, these contrasting experiences raise important questions for policymakers in developing countries: What is the importance of country's having a vibrant local stock market for the country's long–term development? How important are stock markets as a source of investment finance for corporations in developing countries? Is it reasonable to expect many of the small and medium–size firms that account for the bulk of local employment and constitute a significant source of local dynamism and flexibility, but which are unlikely ever to be able to sell their shares in New York or London, to be able to generate significant financing on the local stock market? What is the importance for *low–income* countries of having a stock market?

The question of the importance of stock markets as a source of corporate finance can in turn usefully be broken down into two components. First, what is the relative importance of different *sources* of funds *per se*, i.e. what is the importance of finance derived from new equity issues relative to that derived from intra–firm sources (mainly retained earnings) and from extra–firm debt finance (both intermediated, notably bank loans, and non–intermediated, i.e. bonds and other debt securities)? Part of this component is also the question of whether corporate insiders *desire* to sell more equity but find it difficult to do so, perhaps because of poor corporate governance, or whether they *choose* not to sell more equity, as would be consistent with the well–known "pecking order hypothesis" of corporate finance[19]. Second, how are funds raised on the stock market *used*? 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 to reduce local competition as well?

The evidence from the seven countries suggests that overall the issuing of corporate equity is not a major source of funding for the creation of new production capabilities (a pattern also consistent with the role of stock markets in the historical development of corporate capitalism in the United States and other OECD countries, to which we return briefly below). Equally important, however, is evidence of the considerable extent to which dominant shareholders, in a context of concentrated corporate ownership, make use of non–voting shares, cross–shareholding and especially pyramidal ownership structures to gain access to considerable extra–firm finance — and are thus able to gain such access, moreover, without having to dilute their effective control.

Concentrated corporate ownership structures can of course be understood, as many authors point out, as an appropriate response to serious potential agency problems where there is poor corporate governance and, especially, poor protection of (minority) shareholders' rights[20]. The widespread separation of corporate ownership rights from effective control over corporate resources (with the latter exceeding the former) by dominant shareholders nevertheless means that concentrated ownership may well *not* deprive corporate insiders from access to significant extra–firm finance. In other words, the use of pyramids and other devices to increase dominant shareholders' control over corporate resources may not only allow those shareholders to retain full corporate control. It may constitute a functional alternative to improved corporate governance and better protection of minority shareholders' rights in terms of its allowing corporate insiders to gain access to extra–firm sources of investment finance.

The more serious problem from a development policy perspective may thus not be a shortage of corporate finance as such, but 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. The costs to society as a whole, in terms of wasted resources, lost growth opportunities and foregone development, though difficult to measure, undoubtedly go well beyond those incurred by expropriated minority shareholders alone.

V.1.3 The US Experience

The role played by Wall Street and the New York Stock Exchange in the development of the United States provides useful historical perspective on the role of equity issues as a source of investment finance for corporations. Clearly Wall Street and the NYSE played a central role after the US Civil War (1860–1864) in financing construction of the nation's railroads, whose development was in turn largely responsible for the emergence of a viable national market in the United States towards the end of the 19th century. The creation of a large and rapidly growing *national* market in turn drove the rather sudden emergence, in the 1880s and 1890s, of large industrial corporations that were able significantly to cut costs and establish dominant competitive positions in their respective industries by taking advantage of large economies of scale and scope in production and marketing[21]. While many of these corporations went on to dominate their industries for years to come, their phenomenal growth, from the time of their inception through much of the 20th century, was very largely *self*–financed, i.e. financed through investment of retained earnings.

The stock market's meagre direct contribution to financing the emergence of new industrial firms and the creation of new production capabilities cannot, therefore, be said to have played a major role in US development. Starting before the First World War, and until the NASDAQ phenomenon of the 1990s, the key developmental roles played by the US stock market appear rather to have been *a)* to make it possible for the founder–owners of the large industrial corporations, or their heirs, to sell or significantly reduce their equity in the company, and *b)* to facilitate major corporate merger waves in the 1900s, 1920s and 1960s (as again in the 1980s and 1990s) by allowing firms to acquire other firms through the issuance of equity. A direct consequence was also therefore to promote or facilitate the *separation of ownership from management* in the United States.

The separation of ownership from management had two further important effects. One was greatly to contribute to the *professionalisation of corporate management* — to the emergence of a professional managerial class and the development of a competitive market for managers. The professionalisation of management (along with the emergence of a managerial class, imbued with a "managerial culture", and competitive *markets* for managers) stands in marked contrast to the situation that tends to prevail in heavily relationship–based systems in emerging and developing economies. In the latter a top manager's main "skill" or "asset" is often his close personal ties to top politicians — with all this can imply in terms of self–dealing, clientelistic rent–seeking behaviour and the negative–sum–game dynamics of strategic rivalry within and between powerful distributional cartels, in addition to the expropriation of minority shareholders.

V.1.4 The Importance of Liquidity

The separation of ownership from management in the United States also made it possible for shareholders, often led by corporate founder–owners and their heirs, to *diversify* their corporate equity holdings — spreading their investment risk, and reducing their level of portfolio risk, in the process. The further result was a self–reinforcing process, a virtuous circle, which greatly increased not only the size but also the *liquidity* of the stock market in the United States.

Its significant liquidity in turn made it possible for the US stock market to play an important role in strengthening the entire financial system, and process of development, of the US economy. As recent studies of the positive correlation across countries between the degree of local stock–market liquidity (more than its size *per se*) and the strength of a country's subsequent economic growth further suggest[22], the key to understanding the potential importance for a country's long–term development of the country's having a vibrant stock market appears to be the latter's potential contribution to enhancing the *liquidity* of the country's financial system as a whole.

V.1.5 Banks and Stock Markets: Complements

Measures to strengthen a country's stock market, and its corporate governance as a whole, should thus be understood as a potentially important complement to, but not as a 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[23]. Indeed, for small and medium–size local firms in particular, and for assuring liquidity in a country's financial system — including in low–income countries — a healthy banking system is *sine qua non* for development[24].

An important implication for policymakers and regulators — as Chile's experience points up most clearly, for example — is thus the need for careful attention to the quality of bank supervision and prudential requirements, as well as to bankruptcy rules and procedures. Often equally important is the need to enhance the corporate governance of local *financial* institutions, notably including that of banks[25]. The latter implies a need for attention not only to disclosure requirements, the quality of auditing, etc., but to such questions as whether business groups should be prohibited from having a bank as one of their group firms (as Chile's experience would also seem to recommend) and whether a developing country should or should not require a separation between commercial and investment banking activities[26].

V.1.6 Minority Shareholders' Rights

What about stock markets *per se*, and corporate governance as a whole? Here there can be no doubt of the need to strengthen the effective protection of *minority* shareholders' rights in many of the countries covered in our study. The best means to achieve that protection will not only vary from one country to another, they will usually require the enhancement or modification in a given country of several, perhaps many, of the institutions listed in the annex. Certain key issues can nevertheless be pointed up as requiring policymakers' careful attention.

Two of the most crucial are the questions of how best to combine (and where to draw the line between) *voluntary* and *mandatory* mechanisms of corporate governance, and the use of *judicial* versus *regulatory* means of enforcement. Many countries have found, for example, that mandatory *disclosure* requirements — including mandatory disclosure of a firm's compliance or non–compliance with key (specified) voluntary codes or standards, and of its reasons for eventual non–compliance — combined with an otherwise heavy reliance on voluntary mechanisms is a good approach. Whether such an approach is appropriate where institutions are relatively weak nevertheless leads straight to the issue many see as the single most important: *enforcement*. There is some evidence, for example, that in countries with weak judicial systems (to enforce contracts as well as laws) a regulatory approach to enforcement of *securities* laws by an independent and motivated securities commission can be more effective than judicial enforcement[27]. We touch on this issue again below.

A third issue is the importance to avoid significantly increasing agency costs as the price of trying to reduce the expropriation of minority shareholders. China's experience with its move since 1992 to "corporatise" state–owned companies highlights this danger, as managers have reportedly gained considerable new autonomy to "manage badly" in some of those companies. Concerns have also been raised that calls for greater professionalisation of management in some countries may be more reflective of desires there to increase managers' autonomy than of any commitment to increase their level of professional standards[28].

Policymakers should also note, finally, that significant potential economies of scale and minimum–efficient levels of operation of a stock exchange raise the question for many developing (and OECD) countries — notwithstanding feelings of national pride that may be associated with a country's having its "own" stock exchange(s) — of the potential costs and benefits of merging or consolidating stock markets, perhaps internationally, within their region.

V.2 In the "Real" Sector

Equally if not more important than the potential contribution of improved corporate governance to financial development is its potential contribution to "real" economic development. Significant wastage and misallocation of human and physical capital in countries that suffer critical shortages of both, and volatility often combined with resistance to needed change, widely constitute serious constraints on development, as noted earlier. These are problems towards whose solution improved corporate governance can also 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, or waste, the sizeable real resources they control.

In the "real" as in the financial sector the institutions of corporate governance cannot operate alone. In the financial sector, policymakers must, as noted earlier, 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, policymakers must simultaneously give attention to *three* sets of institutions: *a)* the institutions of *corporate governance per se*; *b)* the institutions of market *competition*; *c)* the institutions of *regulation* that are required in some specific sectors (e.g. telecommunications, air transportation, etc.) including many 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 (Adam Smith's invisible hand) can serve as a major tool to discipline corporate insiders to allocate and use resources efficiently. The problem in many developing countries, as noted earlier, 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 reduce anti–competitive market regulations should help. But many of the countries covered in our study may need to establish or strengthen a domestic competition agency with sufficient political autonomy and resources to be able to monitor compliance with and enforce the rules of healthy price competition. And, as in the case of corporate governance, *competition policy* has not long been on the agenda of policymakers in many developing countries. It needs their attention[29].

Similarly, it is difficult to overstate the importance for policymakers 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. This importance is considerably amplified, moreover, by the risk of regulatory "capture" (which occurs when those with responsibility to regulate a given market are corrupted or otherwise unduly influenced by one or a number of participants in that market) especially where there are strong distributional cartels[30].

It is nevertheless in the dynamics of inter–action among these three sets of institutions — including those of corporate governance — that lies the success or failure for many developing economies of moving away from a situation where negative–sum–games of strategic rivalry within and among powerful distributional cartels tend to overwhelm healthy inter–firm price competition. These economies need to move to a situation where, if the negative–sum games are not eliminated, they no longer trump the benefits of healthy price competition. Only by achieving this movement can there be any hope of achieving reasonably sustained productivity growth.

VI. POLITICAL GOVERNANCE

Negative–sum–games can rarely be eliminated without close attention to the institutions of *political* governance. The very strength of resistance to many of the changes needed significantly to enhance the protection of minority shareholders' rights and to improve corporate governance as a whole, as noted earlier, often exerts itself most strongly (even where corporate insiders may 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, the close interaction between the institutions of political governance and those of corporate governance is clearly reflected in at least three ways: in the central roles of the legislative, regulatory and judicial bodies listed among the institutions of corporate governance in Annex 1; 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 *enforcemen*t 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. Ultimately, they are inseparable.

Particularly relevant in this regard *today* would appear to be the arguments on good political governance put forward by John Locke, in England, and Montesquieu, in France, some three centuries ago. Their views on the importance of establishing a clear and effective s*eparation of powers* and responsibilities among *a)* a representative legislature with oversight capabilities, *b)* a competent and accountable executive branch (including its public administration) and *c)* a fair and independent judiciary — and of establishing an effective system of *checks and balances* among them — constitute the principal conceptual foundations for an effective rules–based system of political governance.

To those ideas one can usefully add the importance of ensuring an effective separation of powers and responsibilities between a strong corporate sector capable of generating sustained productivity growth, on one hand, and strong rules–based institutions of political governance, including well–defined property rights, on the other[31].

The bottom line is that good corporate governance requires good political governance, and vice–versa. Development requires both. Policymakers 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.

VII. CONCLUSION

Corporate governance matters for development. It has a central role to play in helping to increase the flow and lower the cost of the financial capital that firms need to finance their investment activity. The importance of this role has grown considerably in recent years, and is likely to continue to grow, as the needs of corporations for extra–firm finance has grown precisely at a time when the capacity of traditional sources of such finance to supply those needs has greatly diminished.

The significant growth of portfolio equity flows from OECD to developing countries, especially by institutional investors, points to the potential for improved corporate governance in developing countries and emerging markets to contribute to the stability of international financial markets. The potential benefits of such stability are also significant.

Equally important are the potential benefits of improved corporate governance for achieving productivity growth in the *real* economy of many developing countries. Volatility combined with excessive rigidities and huge wastage of real investment resources, both human and material, reflect the actions of distributional cartels in many developing countries. Reflected in ubiquitous self–dealing and rent–seeking behaviour by corporate insiders in a context of clientelistic relationship–based systems of local governance, those actions widely 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 overcome the obstacles to productivity growth.

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. Such attention is important for all countries, notably including low–income developing countries[32]. In the "real" sector, close attention must be given to competition policy and sector–specific regulatory reform, along with the institutions of corporate governance.

Forces working in favour of improved corporate governance in developing countries include those operating both on the demand and on the supply side of portfolio equity flows to corporations there. Those on the demand side include corporations whose extra–firm financial needs have grown as their traditional sources of supply have shrunk; they also include governments responsible for those traditional sources in some cases. Those on the supply side include major institutional investors, especially pension funds and other long–term investors, in OECD and some developing countries. Forces working against significantly improved corporate governance (which may give lip service to the need for such improvement) include many dominant shareholders and other corporate insiders — in the private and public sectors alike — in entrenched distributional cartels.

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. As John Locke might have put it if he were writing today, development requires moving from the rule of man, or woman, to the rule of law — in the institutions of corporate and political governance together.

NOTES

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1. See also Bob Garratt, *The Fish Rots from the Head,* Harper Collins Business, London, 1996.

2. See, for example, A. Shleifer and R. Vishny, "A Survey of Corporate Governance" in *The Journal of Finance,* June 1997; and O. Hart, "Corporate Governance: Some Theory and Implications" *in The Economic Journal,* May 1995. For further discussion of why markets alone are insufficient to ensure sound corporate governance, see for example E. Glaeser, S. Johnson and A. Shleifer, "Coase v. the Coasians", Harvard University and MIT, mimeo, April 2000, and J. Stiglitz, "The Role of the Financial System in Development", Presentation at the Fourth Annual Bank Conference on Development in Latin America and the Caribbean, San Salvador, 29 June 1998.

3. P. Krugman, "The Myth of Asia's Miracle" in *Foreign Affairs*, November/December 1994.

4. Cf. A. Shleifer and R. Vishny, *op. cit*., and O. Hart, *op. cit*.

5. See R. La Porta, F. Lopez–de–Silanes and A. Shleifer, "Corporate Ownership Around the World" in *The Journal of Finance*, 54, 1999.

6. 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.

7. This phenomenon is known in the literature as effective "control rights" that exceed nominal "cash–flow rights".

8. In the United States, where the right to incorporate is granted by state governments, 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 corporation's 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 (see also J. Donahue, "Subnational Business–Attraction Policies in the United States," mimeo, contribution to the Development Centre's research project on the Effects of Competition among Governments to Attract FDI, whose results are presented in C. Oman, *Policy Competition for Foreign Direct Investment*, OECD Development Centre, Paris, 2000).

9. “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.

10. World Bank data.

11. See M. Queisser, *The Second–Generation Pension Reforms in Latin America*, OECD Development Centre, Paris, 1998.

12. See also H. Blommestein, “Institutional Investors, Pension Reform and Emerging Securities Markets”, Inter–American Development Bank Working Paper Series 359, Washington D.C., November 1997.

13. See C. Oman, “The Policy Challenges of Globalisation and Regionalisation”, Policy Brief no. 11, OECD Development Centre, Paris, 1996; C. Oman, *Globalisation and Regionalisation: The Challenge for Developing Countries,* OECD Development Centre, Paris, 1994; and C. Oman, “The Business Model of the New Economy” in *Economic Reform Today*, Center for International Enterprise, Washington D.C., Vol. 1, 2000.

14. See also M. Loriaux, *et al., Capital Ungoverned: Liberalizing Finance in Interventionist States*, Cornell University Press, Ithaca and London, 1997.

15. See M. Olson, *The Rise and Decline of Nations — Economic Growth, Stagflation, and Social Rigidities*, Yale University Press, London and New Haven, 1982, for 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 dollars 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).

16. See Olson, *ibid.*

17. American Depository Receipts are securities backed by shares of non–US incorporated companies that voluntarily comply with US securities laws, making it possible for the securities to be sold on a US stock exchange.

18. Anglo American, Billiton, South African Breweries and Old Mutual have all recently moved their listing from the Johannesburg to the London Stock Exchange.

19. Cf. S. Myers and N. Majluf, “Corporate Finance and Investment Decisions When Firms Have Information That Investors Do Not Have” in the *Journal of Financial Economics*, Vol. 13, 1984.

20. Cf. A. Shleifer and R. Vishny, *op. cit.,* and O. Hart, *op. cit.*

21. See A. Chandler, *The Visible Hand: The Management Revolution in American Business*, Harvard University Press, Cambridge, MA, and London, 1977; and A. Chandler, *Scale and Scope: The Dynamics of Industrial Capitalism*, Harvard University Press, Cambridge, MA, and London, 1990.

22. See R. Levine and S. Zervos, “Stock Markets, Banks, and Economic Growth” in the *American Economic Review,* 88, 1998; and R. Rajan and L. Zingales, “Financial Dependence and Growth” also in the *American Economic Review,* 88, 1998.

23. See also H. Blommestein and M. Spencer, “Sound Finance and the Wealth of Nations” in *North American Journal of Economics and Finance*, Vol. 7, No. 2, 1996.

24. See also J.–C. Berthélemy and A. Varoudakis, *Financial Development Policy and Growth*, OECD Development Centre, Paris, 1996.

25. 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. W. Carlin and C. Mayer, "Finance, Investment and Growth" CEPR Discussion Paper No. 2233, 1999).

26. This issue has also been discussed extensively in the context of the transition countries (e.g. H. Blommestein and M. Spencer, "The Role of Financial Institutioins in the Transformation to a Market Economy", IMF Working Paper WP/93/75, Washington D.C., 1993).

27. See also E. Glaeser, S. Johnson and A. Shleifer, *op. cit.,* which develops this argument based on the recent experiences of Poland, the Czech Republic and Hungary.

28. See J. Shinn, "Globalization, Governance, and the State", Princeton University, mimeo, February 2001.

29. See also C. Oman, "The Contribution of Competition Policy to Economic Development" introductory address in *Competition Policy: 1994 Workshop with the Dynamic Non–Member Economies,* OECD, 1996.

30. See also J. Hellman, G. Jones, D. Kaufman and M. Schankerman, "Measuring Governance and State Capture: The Role of Bureaucrats and Firms in Shaping the Business Environment", European Bank for Reconstruction and Development, Working Paper No. 51, June 2000.

31. To take such inspiration from Locke and Montesquieu, and from Ronald Coase (though his name is not cited above) on the importance of well–defined property rights, may subject these views to criticism, notably from advocates of the concept of "Asian values", that they are too "western" and therefore biased. By way of response to such hypothetical criticism it is interesting to highlight the remarkable parallel between Coase's emphasis on the importance of eliminating ambiguity and establishing clear social norms on the question of who should yield to whom under what circumstances (through well–defined property rights) and the teachings of no less a figure than Confucius with their equally strong emphasis on the importance of eliminating ambiguity and establishing clear social norms on the question of who should yield to whom under what circumstances. Considering that Confucius preceded Coase by more that 2000 years, one might conclude simply that *plus ça change, plus c'est la même chose*.

32. See also H. Bloomestein, "The New Global Financial Landscape Under Stress" in R. Ffrench–Davis, S. Zamagani and J.A. Ocampo, eds., *The Globalisation of Financial Markets and its Effects on the Emerging Countries*, ECLAC and the International Jacques Maritain Institute, Santiago, 2000.

Annex 1

INSTITUTIONS OF CORPORATE GOVERNANCE

The institutions of corporate governance, in any country, can usefully be thought of as comprising key "actors" and formal and informal rules, including generally accepted practices. They include:

- Legislation that gives corporations juridical personality (recognises their existence as legal "persons" independent of their owners), determines corporate chartering requirements, and limits the liability of the owners of a corporation to the value of their equity in the corporation;
- Legislation on 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") empowered to regulate the issuing and trading of corporate securities with the means to monitor and enforce compliance with securities laws;
- Stock–exchange listing requirements (conditions corporations must meet to be allowed to list and trade their shares on the exchange);
- 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, stock brokers, 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 "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*. The former group notably includes rules and accepted practices with respect to:

- 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[1]);
- 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);
- Proscription of self–dealing by corporate insiders (whether self–dealing occurs via related–party transactions[2] or "tunnelling"[3] or takes the form of insider trading[4]);
- Stock–tendering requirements (notably to protect small shareholders in the context of a corporate merger, acquisition or privatisation)[5];
- Judicial recourse for shareholders *vis–à–vis* managers and directors (derivative suits, class–action suits[6]);
- The functioning of markets for corporate control (take–over markets)[7];
- The functioning of markets for professional managers, and of labour markets.

The corporate–governance institutions of *disclosure* and *transparency* notably include rules and accepted practices with respect to:

- Financial accounting standards, and how those standards are set;
- 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 stock brokers, risk–assessment specialists).

NOTES TO ANNEX 1

1. "Anti–director rights" is the expression used by La Porta *et al*. 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 in 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 waved by a shareholders' vote (cf. R. La Porta, F. Lopez–de–Silanes, A Shleifer and R. Vishny, "Law and Finance" in the *Journal of Political Economy*, 106, 1998).

2. "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 has a personal (often family) relationship. Related–party transactions are widely used as a vehicle for self–dealing (see note 9 above) although not all related–party transactions involve self–dealing.

3. "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 7 on p. 32 above) to companies in which they have larger cash–flow rights; it is analogous to asset–stripping. See. S. Johnson, R. La Porta, R. Lopez–de–Silanes and A. Shleifer, "Tunnelling" in the *American Economic Review*, 90, 2000.

4. 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.

5. 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 here in note 1.

6. 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).

7. See also C. Leechor, "Reviving the Market for Corporate Control" in *Private Sector* (published by the World Bank Group), Note No. 191, September 1999.

Annex 2

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