

***“Role of Corporate Governance in the Development of Developing Countries: India”***

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***Abstract:***

This paper investigates the relationship between corporate governance and economic development and well-being. It finds that better corporate frameworks benefit firms through greater access to financing, lower cost of capital, better firm performance, and more favorable treatment of all stakeholders. Numerous studies agree that these channels operate not only at the level of the firms, but in sectors and countries as well—although causality is not always clear. There is also evidence that when a country’s overall corporate governance and property rights system are weak, voluntary and market corporate governance mechanisms have limited effectiveness. Less evidence is available on the direct links between corporate governance and poverty. There are also some specific corporate governance issues in various regions and countries that have not yet been analyzed in detail. In particular, the special corporate governance issues of banks, family-owned firms, and state-owned firms are not well understood, nor are the nature and of determinants of enforcement. Importantly, the dynamic aspects of corporate governance—that is, how corporate governance regimes change over time—have only recently received attention. This paper concludes by identifying some main policy and research issues that require further study.

***Key points: corporate governance, economic development, market based investment process, finance and growth.***

**Introduction:**

Corporate governance, a phrase that not long ago meant little to all but a handful of scholars and shareholders, has now become a mainstream concern—a staple of discussion in corporate boardrooms, academic meetings, and policy circles around the globe. Two events are responsible for the heightened interest in corporate governance. During the wave of financial crises in 1998 in Russia, Asia, and Brazil, the behavior of the corporate sector affected entire economies, and deficiencies in corporate governance endangered the stability of the global financial system.

Just three years later confidence in the corporate sector was sapped by corporate governance scandals in the United States and Europe that triggered some of the largest insolvencies in history. In the aftermath, not only has the phrase corporate governance become nearly a household term, but economists, the corporate world, and policymakers everywhere began to recognize the potential macroeconomic consequences of weak corporate governance systems. The scandals and crises, however, are just manifestations of a number of structural reasons why corporate governance has become more important for economic development and well-being (Becht, Bolton, and Röell 2003).

The private, marketbased investment process is now much more important for most economies than it used to be, and that process is underpinned by better corporate governance. With the size of firms increasing and the role of financial intermediaries and institutional investors growing, the mobilization of capital has increasingly become one step removed from the principal-owner. At the same time, the allocation of capital has become more complex as investment choices have widened with the opening up and liberalization of financial and real markets, and as structural reforms, including price deregulation and increased competition, have increased companies' exposure to market forces risks. These developments have made the monitoring of the use of capital more complex in certain ways, enhancing the need for good corporate governance.

**WHAT IS CORPORATE GOVERNANCE AND WHY IS IT RECEIVING MORE ATTENTION?**

Definitions of corporate governance vary widely. They tend to fall into two categories. The first set of definitions concerns itself with a set of behavioral patterns: that is, the actual behavior of corporations, in terms of such measures as performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders. The second set concerns itself with the normative framework: that is, the rules under which firms are operating—with the rules coming from such sources as the legal system, the judicial system, financial markets, and factor (labor) markets. In a comparative review, the question arises how broadly to define the framework for corporate governance. Under a narrow definition, the focus would be only on the rules in capital markets governing equity investments in publicly listed firms. This would include listing requirements, insider dealing arrangements, disclosure and accounting rules, and protections of minority shareholder rights. Under a definition more specific to the provision of finance, the focus would be on how outside investors protect themselves against expropriation by the insiders. This would include minority right protections and the strength of creditor rights, as reflected in collateral and bankruptcy laws. It could also include such issues as the composition and the rights of the executive directors and the ability to pursue class-action suits.

Corresponding to this broad definition, the objective of a good corporate governance framework would be to maximize the contribution of firms to the overall economy—that is, including all stakeholders. Under this definition, corporate governance would include *the relationship between shareholders, creditors, and corporations; between financial markets, institutions, and corporations; and between employees and corporations. Corporate governance would also encompass the issue of corporate social responsibility, including such aspects as the dealings of the firm with respect to culture and the environment.*

In reality, both institutions and rules matter, and the distinction, while often used, can be misleading. Moreover, both institutions and rules evolve over time. Institutions do not arise in a vacuum and are affected by the rules in the country or the world. Similarly, laws and rules are affected by the country's institutional setup.

In the end, both institutions and rules are endogenous to other factors and conditions in the country. Among these, ownership structures and the role of the state matter for the evolution of institutions and rules through the political economy process. Shleifer and Vishny (1997, p. 738) take a dynamic perspective by stating: *"Corporate governance mechanisms are economic and legal institutions that can be altered through political process."* This dynamic aspect is very relevant in a cross-country review, but has received much less attention from researchers to date. When considering both institutions and rules, it is easy to become bewildered by the scope of institutions and rules that can be thought to matter. An easier way to ask the question of what corporate governance means is to take the functional approach.

This approach recognizes that financial services come in many forms, but that if the services are unbundled, most, if not all, key elements are similar (Bodie and Merton 1995). This line of analysis of the functions—rather than the specific products provided by financial institutions, and markets—has distinguished six types of functions: pooling resources and subdividing shares; transferring resources across time and space; managing risk; generating and providing information; dealing with incentive problems; and resolving competing claims on the wealth generated by the corporation. One can define corporate governance as *the range of institutions and policies that are involved in these functions as they relate to corporations*. Both markets and institutions will, for example, affect the way the corporate governance function of generating and providing high-quality and transparent information is performed.

#### ***Why has corporate governance received more attention lately?***

One reason, mentioned earlier, is the proliferation of scandals and crises. As also mentioned, the scandals and crises are just manifestations of a number of structural reasons why corporate governance has become more important for economic development and a more important policy issue in many countries.

First, the private, market-based investment process—underpinned by good corporate governance—is now much more important for most economies than it used to be. Privatization has raised corporate governance issues in sectors that were previously in the hands of the state. Firms have gone to public markets to seek capital, and mutual societies and partnerships have converted themselves into listed corporations. Second, due to technological progress, liberalization and opening up of financial markets, trade liberalization, and other structural reforms—notably, price deregulation and the removal of restrictions on products and ownership—the allocation within and across countries of capital among competing purposes has become more complex, as has monitoring of the use of capital. This makes good governance more important, but also more difficult.

Third, the mobilization of capital is increasingly one step removed from the principal-owner, given the increasing size of firms and the growing role of financial intermediaries. The role of institutional investors is growing in many countries, with many economies moving away from "pay as you go" retirement systems. This increased delegation of investment has raised the need for good corporate governance arrangements.

Fourth, programs of deregulation and reform have reshaped the local and global financial landscape. Long-standing institutional corporate governance arrangements are being replaced with new institutional arrangements, but in the meantime, inconsistencies and gaps have emerged.

Fifth, international financial integration has increased, and trade and investment flows are increasing. This has led to many cross-border issues in corporate governance. Cross-border investment has been increasing, for example, resulting in meetings of corporate governance cultures that are at times uneasy.

**THE LINK BETWEEN CORPORATE GOVERNANCE AND OTHER FOUNDATIONS OF DEVELOPMENT**

The research on the role of corporate governance for economic development and well-being is best understood from the broader perspective of other foundations for development, notably the importance of finance, the elements of a financial system, property rights, and competition. Four elements of this broad literature are worth highlighting

***The link between finance and growth.***

First, over the past decade, the importance of the financial system for growth and poverty reduction has been clearly established (Levine 1997; World Bank 2001). One demonstration is the link between finance and growth. Almost regardless of how financial development is measured, there is a cross-country association between it and the level of GDP per capita growth. Numerous pieces of evidence have been assembled over the past few years to indicate the relation is a causal one: that is, it is not only the result of better countries having both larger financial systems and growing faster (although that plays an important role). The relationship has been established at the level of countries, industrial sectors, and firms and has consistently survived a rigorous series of econometric probes (as documented in World Bank 2001).

***The link between the development of banking systems and market finance and growth***

Second, and importantly for the analysis of corporate governance, the development both of banking systems and of market finance helps economic growth. Banks and securities markets are complementary in their functions, although markets will naturally play a greater role for listed firms.

It shows that countries that had more liquid stock markets in 1960 have grown faster than those that had less liquid markets from 1976 to 1993.2 For both types of economies, growth per capita is higher if the banking system is more developed. This shows the complementarity between the two.

***The link between legal foundations and growth***

Third, the role of legal foundations is now better understood and documented. Legal foundations matter crucially for a variety of factors that lead to higher growth, including financial market development, external financing, and the quality of investment. Legal foundations include property rights that are clearly defined and enforced and other key regulations (disclosure, accounting, and financial sector regulation and supervision).

Comparative corporate governance research took off following the works of economists Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (La Porta and others 1997, 1998). These two pivotal papers emphasized the importance of law and legal enforcement on the governance of firms, the development of markets, and economic growth. Following these papers, numerous studies have documented institutional differences relevant for financial markets and other aspects.4 These papers have established that the development of a country's financial markets relates to these institutional characteristics and furthermore that institutional characteristics can have direct effects on growth.

Thorsten Beck and colleagues (Beck, Levine, and Loayza 2000), for example, document how the quality of a country's legal system not only influences its financial sector development but also has a separate, additional effect on economic growth. In a cross-country study at a sectoral level, Stijn Claessens and Luc Laeven (2003) report that in weaker legal environments, firms not only obtain less financing but also invest less in intangible assets. Both the less-than-optimal financing and investment patterns in turn affect the economic growth of a sector.

***The role of competition and of output and input markets in disciplining firms***

Fourth, besides financial and capital markets, other factor markets need to function well to prevent corporate governance problems. These real factor markets include all output and input markets, including labor, raw materials, intermediate products, energy, and distribution services. Firms subject to more discipline in the real factor markets are more likely to adjust their operations and management to maximize value added. Corporate governance problems are therefore less severe when competition is already high in real factor markets.

The importance of competition for good corporate governance is true in financial markets, as well. The ability of insiders, for example, to mistreat minority shareholders consistently can depend on the degree of competition and protection. If small shareholders have little alternative but to invest in low-earning assets, for example, controlling shareholders may be more able to provide a below-market return on minority equity. Surprisingly, while well accepted and generally acknowledged (see Khemani and Leechor 2001), there is little empirical evidence that such a complementary relationship exists between corporate governance and competition.

**HOW DOES CORPORATE GOVERNANCE MATTER FOR GROWTH AND DEVELOPMENT?**

The literature has identified several channels through which corporate governance affects growth and development:

- *The first is the increased access to external financing by firms. This in turn can lead to larger investment, higher growth, and greater employment creation.*
- *The second channel is a lowering of the cost of capital and associated higher firm valuation. This makes more investments attractive to investors, also leading to growth and more employment.*
- *The third channel is better operational performance through better allocation of resources and better management. This creates wealth more generally.*
- *Fourth, good corporate governance can be associated with a reduced risk of financial crises. This is particularly important, as financial crises can have large economic and social costs.*
- *Fifth, good corporate governance can mean generally better relationships with all stakeholders. This helps improve social and labor relationships and aspects such as environmental protection.*

**CORPORATE GOVERNANCE REFORM**

The analysis so far suggests that better corporate governance generally pays for firms, markets, and countries. The question then arises why firms, markets, and countries do not adjust and adopt voluntarily better corporate governance measures. The answer is that firms, markets, and countries do adjust to some extent, but that these steps fail to provide the full impact, work only imperfectly, and involve considerable costs. The main reasons for lack of sufficient reform are entrenched owners and managers at the level of firms and political economy factors at the level of markets and countries. Both issues are considered below.

***The role of entrenched owners and managers***

Evidence shows that firms adapt to weaker environments by adopting voluntary corporate governance measures. A firm may adjust its ownership structure, for example, by having more secondary, large blockholders, which can serve as effective monitors of the primary controlling shareholders. This may convince minority shareholders of the firm's willingness to respect their rights. Or a firm may adjust its

dividend behavior if it has difficulty convincing shareholders that it will reinvest properly and for their benefit. These voluntary mechanisms can include hiring more reputable auditors. Since auditors have some reputation at stake as well, they may agree to conduct an audit only if the firm itself is making sufficient efforts to enhance its own corporate governance. The more reputable the auditor, the more the firm needs to adjust its own corporate governance. A firm can also issue capital abroad or list abroad, thereby subjecting itself to higher level of corporate governance and disclosure.

There are also elements of self-selection, with worse firms choosing to list in worse environments. Competition between stock exchanges takes many forms, including not only listing standards, but also the direct cost of trading. This suggests that firms consider several dimensions in selecting where to list. One study, for example, has argued that family-owned firms prefer to choose to list in weak corporate governance environments (with perhaps higher trading costs). These markets would have little incentives to improve their corporate governance standards. By contrast, (large) firms with diversified ownership structures prefer to list in international markets (Coffee 1999 and 2001). Nevertheless, there are many other reasons why firms do not adjust their corporate governance or list in the environment optimal from a cost of capital point of view, including entrenched owners.

### ***The role of political economy factors***

Importantly, countries do not always reform their corporate governance frameworks to achieve the best possible outcomes. In some sense, this is shown by the pervasive importance of the origin of the legal system in a particular country in many analyses and dimensions. Whether a country started with or acquired as a result of colonization a certain legal system some century or more ago still has systematic impact on the features of its legal system today, the performance of its judicial system, the regulation of labor markets, entry by new firms, the development of its financial sector, state ownership, and other important characteristics (Djankov and others 2003). Evidently, countries do not adjust that easily and move to some better standards to fit their own circumstances and meet their own needs.

Partly this is because reforms are multifaceted and require a mixture of legal, regulatory, and market measures, making for difficult and slow progress. Efforts may have to be coordinated among many constituents, including foreign parties. Legal and regulatory changes must take into account enforcement capacity, often a binding constraint. While markets face competition and can adapt themselves, they must operate within the limits given by a country's legal framework. The Nova Mercado in Brazil is a notable exception where the local market has attempted to improve corporate governance standards using voluntary mechanisms.

But it needs to rely on mechanisms such as arbitration to settle corporate governance disputes as an alternative to the poorly functioning judicial system in Brazil. Experiments with self-regulation in corporate governance, as in the Netherlands, have often not been successful.<sup>14</sup> The ability of corporations to borrow the framework from other jurisdictions by listing or raising capital abroad, or even incorporating, is limited to the extent that some local enforcement of rules is needed, particularly concerning minority rights protection (see Seigel 2002 for the case of Mexico).

Corporate governance reforms involve changes in control and power structures. As such, corporate governance reforms can depend on ownership structures. In parts of East Asia, for instance, where considerable corporate sector wealth is held by a small number of families, the degree to which corporate governance standards have been enhanced has been negatively correlated with the share of corporate sector wealth held by those families (Claessens, Djankov, and Lang 1999).

**CONCLUSIONS:**

At the level of the firm, the importance of corporate governance for access to financing, cost of capital, valuation, and performance has been documented in a number of countries. Better corporate governance leads to higher returns on equity and greater efficiency. Across countries, the important role of institutions aimed at contractual and legal enforcement, including corporate governance, has been underscored by the law and finance literature. At the country level, various papers have documented a number of differences in institutional features. Across countries, the relationships between institutional features and development of financial markets, relative corporate sector valuations, efficiency of investment allocation, and economic growth have been shown. Using firm-level data, relationships have been documented between countries' corporate governance frameworks, on the one hand, and performance, valuation, cost of capital, and access to external financing, on the other. Institutional investors are increasing throughout the world, and their role in corporate governance of firms is consequently becoming more important. But the role of institutional investors in corporate governance is not obvious. In many countries, institutional investors have purposely been assigned little role in corporate governance, as more activism was considered to risk the company's fiduciary obligations. Furthermore, the governance of the institutional investors themselves is an issue, as they will not

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