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Corporate Governance Research in Emerging Economies: The Need for Alternative Perspectives

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Abstract

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This paper argues that corporate governance research in emerging economies is dominated by agency theory perspective. While agency theory is important in explaining corporate governance in these economies, this paper argues that it is not sufficient. Alternative perspectives are needed in explaining the practice of corporate governance in emerging economies more holistically as emerging economies have different institutional context and non-economic factors as compared to more advanced economies. In doing so, this paper reviews corporate governance literature, focusing on those studies conducted in emerging economies, with the purpose to provide a detailed commentary on the nature of existing research on corporate governance in these economies and identify gaps in this literature. This paper proceeds by explaining on why Agency Theory is not sufficient and suggests for future work.

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Keywords: Corporate Governance; developing economies; agency theory; institution.

1. Introduction

Review of corporate governance literature shows that both research and practices of corporate governance are dominated by the agency theory. Under this perspective, corporate governance is seen as a mechanism by which to deal with the issue of separation of ownership and control. Research and practice focus on how to reduce the loss of the firm's value as a result of this separation of ownership and control. Review of literature also shows that despite the dominance of the economic perspective, efforts have been made to explain corporate governance from other views including institutional view, power, and politics. However, in emerging economies, research utilizing institutional perspective is



still lacking. Hence, this paper aims to illustrate why agency theory is insufficient to explain corporate governance practices in emerging economies and to suggest that future research should pay more attention to institutional context and other non-economic factors affecting corporate governance in emerging economies.

This paper is structured as follows; it starts with a discussion as to why there have been many interests on corporate governance. The focus is then shifted onto discovering what has been studied before. This then brings the domination of agency theory perspective into the discussion, as well as a few other perspectives which complement, rather than substitute, agency theory. This is then followed by a section that covers corporate governance research in emerging economies; then discussion on limitations of agency theory; followed by a concluding comment.

2. The Importance of corporate governance

The concern related to corporate governance has existed for many decades ever since joint stock companies moved into the mainstream of the global economy; particularly with the issues of inefficiency and corporate failures (see Smith, 1776). Berle and Means (1932) then revealed that, despite their benefits, there are issues related to the structure of modern companies. The structure of modern companies in the US, characterised by a separation of ownership and control, had engendered a situation where the true owners of companies, the shareholders, had little influence over the companies' management.

The problem revealed here formed the basis of the agency problem, where managers may not act in the interest of owners due to differences in motivations (Sorensen, 1974). Much of the economic literature relating to the problems of moral hazards was then concerned with problems raised by the agency (Ross, 1973). Principals, therefore, struggle to control and monitor the activities of the agents. In 1976, Jensen and Meckling published a study that shed light as to how companies could survive this agency issue. In developing the theory of ownership structure, they discussed the roles of incentives, monitoring, and bonding activities in reducing agency costs while still retaining maximizing behaviour of agents. Principal-agent model, thus, generates a classic trade-off between incentives and risk sharing. It provides an insight into why managers are given performance-related pay in the form of shares or stock options (Hart, 1995).

Although corporate governance systems have long existed in the corporate world, the expression only started to appear in American law journals in the 1970s. It was then imported to the UK and has become widely discussed in the last two decades in both countries (Banks, 2004, p. 3; O'Sullivan, 2000, p. 1). By the late 1990s, it had become a major issue in all other advanced economies and, increasingly, in developing countries as well (O'Sullivan, 2000), due to privatisation, pension deregulation, free capital movement or capitalism globalization, market integration, and corporate scandals (Banks, 2004; Becht et al., 2005).

Another important factor that drives the demand for good corporate governance globally is the presence of institutional investors dominated by the US and UK (Gregory, 2001), as well as cross-listing between the US, UK and Europe. There are also foreign investors present in developing economies and foreign investors in US financial markets as well. Emerging economies then adopted

the framework from the developed nations, especially the Anglo-American systems (Young et al., 2008). The following section discusses existing research in corporate governance, which is dominated by agency theory.

3. The domination of economic perspective

As mentioned earlier, research in corporate governance is dominated by economic perspectives, in particular the agency theory. The focus of agency theory is to determine the most efficient contract governing the principal- relationship (Eisenhardt, 1989). The development of agency theory, however, has resulted in two separate lines of literatures, namely: the positive theory of agency and the principal-agent theory of agency (Jensen, 1983). Research in corporate governance has been developed under the positive stream of agency theory.

Positive theory relates to discovering how the world behaves; positivist researchers of agency have focused on explaining the governance mechanisms in solving the agency problem (Eisenhardt, 1989). It focuses on “modelling the effects of additional aspects of the contracting environment and the technology of monitoring and bonding on the form of contracts and organizations that survive” (Jensen, 1983, p. 334). Three influential, earlier articles on positive agency stream cited ownership by managers (Jensen & Meckling, 1976), efficient capital and labour market (Fama, 1980), as well as board of directors (Fama & Jensen, 1983) as important governance mechanisms to control the behaviour of agents. Both efficient capital markets and board of directors act as information mechanisms that are used to control and monitor the self-serving behaviour of top executives.

In the 90s research utilizing non-US data started to appear. Denis and McConnell (2003) label them as the first generation and second generation of research. The first generation of research refers to those patterned after the US research that preceded it, in particular, board composition and equity ownership. It started with research efforts conducted in three advanced economies, i.e. UK, Germany, and Japan; followed by other advanced economies, especially in Europe. The second generation of research considers the possible impact of differing legal systems on the structure and effectiveness of corporate governance and compares systems across countries. The attention to legal systems in corporate governance studies begins with the study conducted by La Porta et al. (1998), which investigates how the existence of laws protecting investors and the quality of enforcement of the laws determine corporate ownership patterns in a country. Hence, the attention to legal systems provides a more complete understanding of the roles of firm-specific corporate governance, such as board of directors and equity ownership. Research in emerging economies follows the first generation strand; appearing after other advanced economies.

4. Corporate governance research in emerging economies

Changes in the domestic economies of emerging countries in the 1980s and 1990s have led them to undertake market-oriented economic reforms, which saw them implement widespread privatization, liberalization of economies, as well as expanding market institutions, such as the stock markets. This development means that, at their national level, corporate governance has started to become important. However, the Asian crisis in the late 1990s, as well as other crises in other emerging economies, has

then made corporate governance not only a national concern for these countries, but also a concern at the international level due to its spill-over effects (Singh, 2003). Attention then led to increasing research being conducted post-Asian crises, as more resources were being outlaid by international financial organizations to finance research in these economies.

Review of corporate governance literature in emerging economies shows that research in these countries mirrored those conducted in more advanced economies, in particular the US, by focusing on equity ownership structure and board composition to address agency issues. This stream of research also has been focusing on the following: privatization and agency issues (Dharwadkar, George, & Brandes, 2000); the role of ownership structure and investor protection in post-privatization companies (Boubakri, Cosset, & Guedhami, 2005); shareholder activism (Sarkar & Sarkar, 2000); comparative studies of ownership structure and firms' performance (Claessens & Fan, 2002; Lemmon & Lins, 2003; Mitton, 2002), and finally, the overall corporate governance effectiveness in emerging markets (Gibson, 2003).

Another stream of research focuses on the adoption of the corporate governance codes of best practices by the emerging economies from the more developed nations, in particular, the Anglo-Saxon system. The adoptions occur through internally-driven reform, such as China and Russia; or as a response to international demand (Young et al., 2008). Organizations such as the World Bank and the International Monetary Fund (IMF) have routinely recommended emerging economies to adopt the US system of corporate governance, as well as a stock-market based financial system (Singh et al., 2005) as the US system is claimed to be economically more efficient than others (Gugler, Mueller, & Yurtoglu, 2004). From a different perspective, adoption could be for efficiency reasons, or simply for legitimacy (Aguilera & Cuervo-Cazurra, 2004).

However, subsequent works question these adoption efforts as they argued that there exist institutional differences in these markets which should not be ignored when making corporate governance policies. Some argue that the recommendations are seriously inappropriate in their context (Singh et al., 2005; Uddin & Choudhury, 2008). The utilization of agency theory is also questioned. Emerging markets normally have weak markets for corporate control or a different capital market structure (Singh et al., 2005), as well as relatively weaker institutions, including corporate governance institutions (Young et al., 2008). Different institutions create different governance issues; and these differences affect the implementation of corporate governance recommendations (for example, Gibson, 2003). Hence, using policies designed for developed economies may prove ineffective or even counter-productive in emerging economies (Young et al., 2008). Not only that, too many reform initiatives have been partial and poorly conceived; as well as being undertaken without considering the fundamental interdependence between corporate law and corporate finance, and between corporate governance and the rest of the economic system. Besides, appropriate governance structures are also historically and politically contingent (Roe, 1991). Hence, any recommendation for policy must be based on an analysis of the specific governance problem in the given country and needs to define the corporate governance problem in the particular country with regard to its prevailing institutions.

The codes of best practices found in the Anglo-American system are developed based on agency theory, which means that the codes are developed based on the premise that the main corporate

governance problem is self-interested management and weak, dispersed shareholders. This empirical context is in fact highly unrepresentative when taken outside the US and the UK, since most firms in the world have a dominant owner. In fact, high concentrated ownership is a feature of publicly listed companies in emerging economies (Fan & Wong, 2005); where families or the state hold a dominant stake. The organizational activities in emerging economies can differ considerably from those found in developed economies (Wright et al., 2005), and corporate governance problems in these economies may require different solutions from those generated from an agency theory perspective. Claessens et al. (1999), for example, suggests that the main corporate governance problem in the emerging markets, especially in Indonesia, Philippines and Thailand, is the expropriation of minority shareholders by controlling shareholders.

The implications of these institutional differences are many; for example, the cost of capital in these markets is higher due to their relatively weak institutions (Young et al., 2008). Fan and Wong (2005) argue that, in emerging markets, the agency conflicts between controlling owners and minority shareholders are difficult to mitigate through conventional corporate control mechanisms, including board of directors. The corporate governance system also could be affected by firm capabilities and behaviors, which in turn, are influenced by local, non-economic factors (Millar, Eldomiaty, Choi, & Hilton, 2005). They noted that differences in the corporate governance structure result from differences in institutional arrangements linked to different business systems or models of capitalism, which in turn determine institutional transparency (Millar et al., 2005). They posit that the relationship-based corporate governance of Asia's emerging markets is characterized by the government's orientation towards providing subsidized credit to firms in targeted industrial sectors and implicitly sharing the risk which acted against institutional transparency.

Other works related to emerging markets are those that have focused on government intervention (Boubakri et al., 2005; Fan et al., 2011; Fan, Wong, & Zhang, 2007). Fan et al. (2007) investigate how corporate governance and board composition in Chinese firms are related to government intervention and conclude that the country's partial privatization and ongoing government intervention through the appointment of CEOs are not conducive to shareholder value maximization. However, government intervention is one of the key institutional forces in emerging markets that impact upon the structures and behaviors of firms including their investments, financing, governance, and growth; others being government quality, the extent of state ownership, and the degree of financial development.

The review of corporate governance literature in emerging markets as above shows that although attention has later been directed towards institutions, these studies are based on an agency theory perspective which focuses on corporate governance as a mechanism by which to address the agency conflicts. There appears to be a lack of studies utilizing institutional perspective and giving evidence on how various institutions constrain corporate governance actors' actions. The following section further discusses the limitations of agency theory in explaining corporate governance practices in emerging economies.

5. Limitations of agency theory

The review of the literature above shows that there exist gaps in corporate governance literature, of which gaining insights or filling those gaps could help to better understand corporate governance practices. While the dominant perspective in corporate governance research comes from an economic perspective, this paper proposes that future studies should employ alternative perspectives in studying corporate governance in emerging economies. This is because, as important as it is, corporate governance is a secondary institution influenced by much larger institutional and social forces. Understanding those forces would help in understanding corporate governance not as a mechanism dealing with agency issues but also seeing corporate governance as a political as well as a social instrument.

The flaws of agency theory in explaining corporate governance mechanisms are noted by Professor Victor Brudney (1985) when he argues against the analysis that claims that private bargaining or contracting sufficiently restrains management misbehaviour. Instead, he acknowledged the importance of institutions. His argument is not in isolation, as Roe (1991) also found that the initial separation of ownership and control in the US, at least in the 1930s, was due to legal and political factors; and not as an automatic response to the development of their firms. Also criticizing agency theory, Van Essen (2011) looks at the role of ownership in different contexts by taking into account the different formal and informal institutional constellations found in those contexts. He found that who owns the firms matters in respect to the firms' strategies, objectives, and performance; i.e. a crucial factor with respect to the ownership concentration, firm strategy and performance relationships, is owner identity. While Van Essen (2011) has been investigating ownership from the institutional perspective, his focus is on the role of ownership and not about how the ownership structure is shaped.

In relation to studies of board of directors also, although agency theory has been dominating corporate governance literature, it is, however, claimed to have provided very little information regarding actual board functioning and behaviour (Petrovic, 2008). Hence there is a call for greater theoretical pluralism and more detailed attention to board processes and dynamics (Roberts et al., 2005). They suggest that it is the actual conduct of the directors that determines board effectiveness; while board structure, composition, and independence only condition it. Looking at the roles played by the audit committee, Humphrey (2008) also appears skeptical as there is not much known about their day-to-day practices and how have they managed to provide a convincing solution or strategic development when corporate governance contains structural flaws. Turley and Zaman (2007) found that the most significant effects of the audit committee on governance occur outside the formal structure and processes. This is consistent with an earlier observation that corporate governance is a social process, and hence, should also be investigated from a social perspective.

Aguilera et al. (2008), in challenging agency and stakeholder perspectives (which they termed 'closed system'), propose an organizational sociology approach to comparative corporate governance in order to better capture the patterned variation that results from interdependencies between firms and their environment. Their 'open system' perspective views corporate governance in terms of effectiveness in achieving their goals. They adopt a much broader definition of effectiveness as opposed to agency theory where effectiveness is "the accountability of corporate decision-makers and

the legitimacy of decisions about their different economic and non-economic goals and values” (p. 476). Their proposed framework is comprehensive for assessing how an institutional context affects the appropriateness of an alternative governance process.

Hambrick, Werder, and Zajac (2008, p. 381) see corporate governance as referring to “the formal structures, informal structures, and processes that exist in oversight roles and responsibilities in the corporate context.” They show how governance themes, and research on those themes, can span a level of analysis in both the micro direction and macro direction. The law and economics literatures tend to focus on the roles of formal structures in governance. Research on behavioural structure or informal structure tends to focus on power issues between and among key corporate actors; i.e. power struggles between managers and their overseers. Behavioural structure relates to who has the most power and influence within the boardroom and who has the least. Power differentials within a board helps explain variance in firm outcomes and increase our understanding of board actions and inactions. Theoretical and empirical studies from emerging economies is needed to show how these power differentials could exist and affecting corporate boards in emerging economies.

6. Conclusion

The purpose of this paper is to provide an overview of the trend or focus in the research of corporate governance with the aim of identifying the gaps in the existing literature. The review notes that although corporate governance research is dominated by an economic perspective, in particular the agency theory, there has been an increasing effort to study corporate governance from broader perspectives. However, in emerging economies, corporate governance research is still dominated by agency theory and not much focus has been given to institutional context and other non-economic factors. Although influential, the agency theory is unable to provide sufficient understanding on many issues related to practices due to the fact that corporate governance is not happening in a vacuum; it is affected by social mechanisms. Hence, alternative perspectives are needed to explain corporate governance practices, in particular, corporate governance practices in emerging economies.

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