



Corporate Governance and Development

Reform, Financial Systems and Legal Frameworks

Edited by
Thankom Gopinath Arun
John Turner

The CRC Series on Competition,
Regulation and Development

Corporate Governance and Development

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Frameworks

Edited by

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THE CRC SERIES ON COMPETITION, REGULATION AND
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Corporate Governance and Development

THE CRC SERIES ON COMPETITION, REGULATION AND DEVELOPMENT

Series Editors: Paul Cook, *Professor of Economics and Development Policy, Institute for Development Policy and Management, Director of the Centre on Regulation and Competition (CRC) and Director, Competition Research Programme in the CRC, University of Manchester, UK* and Martin Minogue, *Senior Research Fellow, Institute for Development Policy and Management and Director of the Regulatory Governance Research Programme, CRC, University of Manchester, UK*

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Corporate Governance and Development
Reform, Financial Systems and Legal Frameworks
Edited by Thankom Gopinath Arun and John Turner

To my parents and Shoba
To Karen and Jack

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Preface

The subject of corporate governance is concerned with assuring providers of capital (shareholders, creditors and employees) that their investment will not be misused or misappropriated by corporate insiders such as large shareholders or managers. This book analyses the complex relationship between corporate governance and economic development by mainly focusing on the reform of corporate governance, the role of the legal system in corporate governance, and the interconnections between corporate governance and the financial system.

Economic liberalization has increased the economic power of many firms, which may have had a negative impact both on the welfare of society and economic efficiency. Consequently, this has enhanced the need for an appropriate legal and regulatory framework, which would help to protect capital providers and safeguard consumers. Financial market liberalization, an integral part of economic reform, has opened up a renewed focus on the issue of regulation, corporate governance and development. However, research and policy dialogue on the interrelationship between these three themes have been quite compartmentalized both in terms of disciplinary and thematic boundaries. This has minimized the scope of the discussions as to what extent regulation and corporate governance are instrumental in safeguarding investments, both financial and human, and leads to wider questions on international development both in terms of stability and sustainability.

The initial idea for this book emerged from a one-day multi-disciplinary conference entitled 'Competition, Regulation and Development' organized by the Centre on Regulation and Competition at the University of Manchester in November 2007. The conference explored the role of corporate governance in economic development in general and the interrelationship between regulatory shortcomings and corporate governance in particular.

The selected papers from the conference have been revised based on editorial comments and in line with the main themes presented in the volume. This volume offers a one-stop reference guide for practitioners, academics, researchers, donor agencies and to those who are interested in understanding the multi-dimensional/disciplinary aspects of corporate governance. We are greatly indebted to the contributing authors for making their work

available to us and their cooperation in revising their drafts. The chapters in the book cover the key issues in corporate governance and the broad thrust of the various contributions to this edited volume is that the subject of corporate governance must become a growing priority for policymakers in developing nations. Poor governance can result in lower investment in long-term projects, having a detrimental effect on social welfare. In addition, major corporate failures remind us that poor corporate governance can seriously affect the lives of thousands of people – investors, savers, creditors, retirees, employees, suppliers, and consumers.

Finally, we must express our gratitude to those publishers of two original papers in the volume. We are especially thankful to Paul Cook and Martin Minogue for their support in listing the book in the CRC Book series.

Thankom Gopinath Arun
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1. Corporate governance and development: reform, financial systems and legal framework – an overview

Thankom Gopinath Arun and John Turner

INTRODUCTION

The initial idea for this book emerged from a conference entitled *Competition, Regulation and Development* organized by the Centre on Regulation and Competition at the University of Manchester in November 2007. The selected papers from the conference have been revised based on editorial comments and in line with the main themes presented in the volume. We are greatly indebted to the contributing authors for making their work available to us and their cooperation in revising their drafts.

Since the genesis of the corporation (or company), there has been a concern with what we now term corporate governance. Notably, even Adam Smith (1999) in *The Wealth of Nations* alludes to governance problems in early corporations. This book analyses the complex relationship between corporate governance and economic development by focusing on the reform of corporate governance, the role of the legal system in corporate governance, and the interconnections between corporate governance and the financial system. Although economists have typically viewed corporate governance as the ways by which investors assure themselves of getting a return on their investment, this book takes a broader view on the topic by developing a multi-dimensional perspective from disparate disciplines such as development studies, law, economics and finance.

In the finance and economics literature, there has been considerable debate as to whether finance ultimately matters for economic growth (Levine, 2004). Adherents of the Modigliani-Miller school argue that it is real investments which matter, not how they are financed. For example, Lucas (1988) argues that finance doesn't matter for economic growth. Taken to its logical conclusion, this perspective implies that how businesses are organized, governed and financed does not affect their value,

and hence the performance of the overall economy. An alternative view, going back to Schumpeter (1912), is that finance is an important engine of economic growth. This view was given impetus by the seminal works of Goldsmith (1969), Shaw (1973) and McKinnon (1973). Since the late 1980s there has been a plethora of empirical studies examining the impact of finance on growth. On the whole, the empirical evidence suggests that the impact of financial development on growth is positive (King and Levine, 1993a, 1993b; Levine, 1997; Levine and Zervos, 1998; Beck and Levine, 2004; Levine, 2004). Indeed, the growing consensus is that finance does matter for development, and as a result, policy-makers have been paying closer attention to the structure and organization of financial systems. In particular, strenuous attempts have been made to strengthen the financial systems of developing economies (e.g. Arun and Turner, 2002).

If finance matters for economic development, then corporate governance must also affect economic development for at least two reasons. First, corporate governance affects how and at what cost firms finance their real investments. Poor corporate governance can have a detrimental impact on a firm's performance, and if it is an endemic problem in a country, it will undoubtedly have a major impact on economic growth. Secondly, the quality and nature of corporate governance can affect the structure of the financial system. If shareholders are poorly protected and companies are poorly governed, then one would not expect to see a thriving market for publicly-traded equity. Instead, most external business finance will be provided by banks.

The broad thrust of the various contributions to this edited volume is that the subject of corporate governance must become a growing priority for policymakers in developing nations. Poor governance can result in lower investment in long-term projects, having a detrimental effect on social welfare and affect the lives of many.

Financial crises in South-East Asia, Russia and Brazil have alerted policymakers to the problems of poor quality of corporate governance in developing countries. The seminal work by OECD in this regard clarifies the importance of corporate governance from a long-term development perspective, by analysing the institutional conditions and actual functioning/malfunctioning of corporate governance (Lin, 2001; Malherbe and Segal, 2001; Oman, 2001). The findings of this work emphasize that the quality of corporate governance matters significantly for developing countries in contributing to a country's ability to achieve sustained productivity growth and lasting democratic political institutions, both of which are crucial for long-term national development.

Corporate governance has a significant role to increase the flow and lower the cost of the financial capital and the importance of this role is likely to