CORPORATE GOVERNANCE AND COMPETITION: CONCEPTUAL THOUGHTS

Masrur Reaz, Thankom Arun*

Abstract

This study attempts to explore the theoretical and empirical evidence on the relationship between competition and corporate governance in the broader back ground of economic reforms in developing economies, and analyses the problems that may occur due to inadequate corporate governance practices in an enhanced era of competition. The paper also discusses the areas of corporate governance that required immediate attention in developing countries such as protecting shareholder rights and market for corporate control, which are emerging issues in the context of rapid privatisation and deregulations.

Keyword: Corporate Governance, ownership, competition

** Institute for Development Policy and Management, School of Environment and Development*
The University of Manchester

1. Introduction

The expanding role of the private sector and the recent global financial crises have generated the discussion on competition and corporate governance in developing countries, and provided impetus for implementing adequate corporate governance practices. Until recently, only a few firms held majority share of the product and service markets in most of the developing countries, owned by a small group of large shareholders[1]. The interest in promoting competition has increased as part of the 'move to the market' wave initiated as part of economic reform in many countries. The idea was that the deregulation/privatisation process stimulates the process of competition by allowing more players in competitive market conditions[2]. Also, an added emphasis was given to the private sector development which improves allocative and productive efficiency, and enhances the scope for competition. However, the contemporary wave of mergers and anti-competitive practices has further raised the awareness of effective corporate governance practices to maintain competitive market conditions. There is a need for change in corporate governance related policies as the intensity of market competition changes, or else the economies may not attain the benefits of deregulation, rather it could lead to collapse of more firms as it is difficult for inefficient firms to survive in strong competition. How the corporate governance practices in developing countries needs to be reformed to address the concerns on efficiency and competition is the main concern addressed in this paper.

Although, as a concept corporate governance has been in practice for a long time, the term 'Corporate Governance' has been in use since late 1980s only. More than two hundred years ago, Adam Smith echoed the need for the separation of ownership and control in his famous book The Wealth of Nation (1776). Later on, Berle and Means (1932), considered to be the pioneers in the contemporary thinking about corporate governance, drew attention to the growing separation of power between the executive management of the major public companies and their increasingly diverse and remote shareholders .With many seminal studies in the following years such as Mace (1971) on director behaviour, Jensen and Meckling (1976) which led to development of Agency Theory, added with events in the economic and corporate world such as financial crises in different parts of the world and failures of companies like Maxwell and BCCI, the term corporate governance gained fame and

[1] In contrast, in UK 100 per cent of the top 20 publicly traded companies are widely held and in USA it is 80 per cent (Singh et al, 2002). In another study, World Bank (1993) shows that market concentration (four- firm ratio) for United States is 40 per cent but for Pakistan, Brazil, Turkey, Chile, all of who fall under the developing bracket, the ratio is above 50 per cent.

[2] However, some are arguing that intense competition exerts negative effect on productivity growth that could affect the level of private investments (Singh and Dhumale, 1999).

VIRTUS NTERPRESS®

generated immense interests by the decade of 1980 (Corporate Governance, 2000).

The issue of corporate governance deals with the ways in which suppliers of finance to corporations make ensure fair return on their investments (Shleifer and Vishny, 1997). Corporate governance deals with mechanisms within which a corporation conducts its basic operations. Thus we can say that corporate governance itself is a mechanism through which it is ensured that corporations are directed toward the right way, which will take best care of parties concerned. Monks and Minnow (1995) say that corporate governance seeks to deal with systems, mechanisms and modalities of exercising power and control over the corporation's direction, behaviour and performance. Turnbull (1997) suggest the corporate governance as a set of influence which affects the institutional processes such as appointment of regulators, organizing the production and sale of goods and services and also noted that corporate governance includes all types of firms whether or not they are incorporated under civil law. Section 2 of the paper provides a conceptual discussion on the interrelationship between Corporate Governance and Competition. Section 3 analyses the issues on shareholding policies and governance mechanisms such as policies on incentives and disclosure. Section 4 summarises the main conclusions of the study.

2. Corporate Governance and Competition

The central issue of how to construct rules and incentives to effectively align the behaviour of managers with the desires of principals was the leading research agenda in corporate governance until 1970s. In 1970s, Alchain & Demsetz (1972) and Jensen & Mecklings (1976) came up with new theories, which changed the focus of corporate governance from the so called 'managerialism' to the concept of 'firm' itself. This approach confers the importance of the internal dynamics of the firm and considers the firm as a bunch of contracts between different partners of factors of production. This is a notable variation from the previous view of firm as a single product entity committed to profit maximization only (Learmount, 2002, Shleifer & Vishny, 1997), and a view which has significant implications on competition at the firm level.

The market based approach has further advanced thoughts in this direction and engaged a view that the firms always take the best care of its shareholders. However, the Stakeholder theorist such as Clarkson (1994) argues that the firm is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm's activities. The key to achieving this is to enhance the ownership-like incentives to those participants in the firm who contribute or control specialized inputs (firm specific human capital) and to align the interests of these critical stakeholders with the interests of passive shareholders (Blair 1995, pp 322). There is a criticism is that the stakeholder theory supports to passive shareholders who would like to have free lunch without accountability. In recent days, the role of competition as a governance mechanism meant a shift in the focus to the capital market as a way of disciplining managers and ensuring that managers pursue the shareholders interest. The stewardship approach of corporate governance presupposes that managers or the board of a firm are self-motivated to serve the best interest of the firm and its owners. Donaldson and Davis (1994) assume that managers are good stewards of the corporations who work very hard to increase the corporate profit and shareholder return.

Many studies have identified that competition in product markets is a very powerful force for implementing good corporate governance practices (Alchian 1950, and Stigler 1958 quoted in Allen and Gale 2000). The problems of asymmetric information, transaction cost and other capital market imperfections are ubiquitous in developing economies and most of them have no active market for corporate control (Glen, Lee and Singh 2000). Despite the high levels of competition, even in large corporations the interests of managers and owners may differ on optimal strategies to deal with competition (Schliefer and Vishny 1997). The effective competition with desired positive effects would be possible only with the adequate development of supporting structures such as sufficient and appropriate legal back up, regulatory policies and policies regarding good governance of firms. Sound corporate governance practices ensures that a firm is run by its management as well shareholders in the right direction which upholds the interest of owners and stakeholders. Enhanced competition without improving the quality of corporate governance may create opportunity for corrupt entrepreneurs and managers to embezzle peoples' hard earned savings.

The role of the political marketplace is also an important variable to understand the dynamics of capital market mechanisms in ensuring corporate governance particularly to determine the allocation of power, privileges, and profits are allocated between owners, managers and other stakeholders (Turnbull, 1997). Firms which survive intense competition are thought to have optimal governance structure and firms which fail to acclimatize their governance structures to changes in the business environment supposedly face extinction, leading to a natural selection of efficient organizations (Alchian, 1950). During the period of deregulation, the systems of management incentives and monitoring needs to change significantly to avoid the chances of extinction due to bad decisions, which is higher in a competitive environment (Kole and Lehn, 1997). Also studies have proved that if the corporate

governance practices and competition were complementing each other then the impact of product market competition would be greater in firms with efficient governance structures (Grosfeld and Tresse, 2001). This conceptual discussion underlines the need for strengthening corporate governance practices of firms as the markets are liberalized to enhance the nature and patterns of competition. One area of corporate governance which requires an immediate attention as a determinant to competitive market condition is that on the pattern of shareholding in firms, which is discussed next.

3. Shareholding Policies and Governance Mechanisms

The economic reforms have initiated wider debate on the relationship between the pattern of shareholding in firms and the firm performance in developing economies. In US, large outside shareholders increases the likelihood that a firm is taken over and forces the management to work in line with the shareholders' interest (Shivdasani, 1993). Two studies on Japan by Kaplan and Minton (1994) and Kang and Shivdasani (1995) shows that firms with large shareholders are more likely to replace managers for poor performance compared to those firms without large investors. In Germany, 80 per cent of the large companies have an average of over 25 per cent non-bank large shareholder (Gorton and Schimid, 1996). Smaller German companies are usually controlled by family through majority ownership or pyramids in which the owner controls 51 per cent of a company which will in turn control 51 per cent of its subsidiaries (Frank and Mayer, 1994). However large investors may be motivated by their own self interests such as possible expropriation of the investments when the large investors own equity with greater voting rights or through the pyramid structure (Shleifer and Vishny, 1997; Grossman and Hart, 1988; Harris and Raviv, 1988).

The Corporate sector in developing countries is typically characterised by heavily concentrated shareholdings in the hands of large investors such as families or the government (La Porta et.al, 1998, 1999). The nature of shareholding in deregulated markets largely depends on external factors such as legal systems and institutional frameworks. The appropriate mechanisms that protect shareholders' right such as market for corporate control, effective audit and disclosure policies are important to encourage dispersed shareholding in a deregulated market environment. Otherwise, the managers of firms may misappropriate shareholders' money by taking advantage of small shareholders' lack of power and motivation to closely monitor the executives. Stiglitz (1999) emphasised that with dispersed ownership, one needs to see the rapid evolution of effective securities market and clear protection of shareholder rights. Black (2000) has outlined five institutions for effective monitoring in a dispersed ownership scenario - effective regulation of securities market, accounting rules, independent audits, and extensive financial disclosure, a sophisticated accounting banking profession, a stock exchange with meaningful listing standards, and, company and insider liability for false or misleading information.

Increased competition seeks the benefits of spreading products or services to a greater number of populations at a more reasonable price level. In order to attain this vital goal, firms operating in the liberalized market must strictly conduct their business in ways which primarily aim at boosting the firms' efficiency and performance. The ownership pattern and structures have a determining role in the functioning of firms. Although the large shareholders have been cited as efficient monitors, there are concerns that such block holders, taking advantage of their large voting rights, may direct the firms in a way which are only beneficial to themselves at the expense of other stock and stakeholders (Shlifer and Vishny, 1997). Similarly, executives may be acting in a way which is most beneficial to them as well where shareholding is much dispersed. In both cases self dealing by owners and/or management could lead to the inefficient performance of the firms and their possible extinction.

The other issue which needs immediate attention in deregulated environment is on the changing dimensions of public-private and foreign firms. This issue becomes a sensitive one in many countries where the public/government ownership comes into focus. In most cases private and the foreign firms employ governance mechanisms better than public sector, to enhance or maintain high levels of efficiency. However publicly owned firms still dominate the markets with large market shares in most of the deregulated markets. For example in Bangladesh banking sector which was liberalized in early 1980s, four publicly owned commercial banks still control 50 per cent of the assets and deposits while the rest is shared by 30 local private and 10 foreign banks. The reasons for the large government ownership in the banking sector may be due to solve the inherent informational problems in developing financial system, aiding the development process or supporting vested interests and distributional cartels (Arun and Turner, 2002). However, in the absence of market provided incentives, the managers of the public sector organisations may be able to engage in opportunism at the tax payer's expense, which supports the need for reforming the public sector organisation in developing countries in a time bounded manner.

The ownership pattern and structures of firms plays a crucial role in achieving the desired positive outcomes of enhanced competition in developing countries. Markets with presence of large shareholders whether it is public or private must

develop effective regulations. Similarly a strong and active capital market must be enacted in order to have optimum ownership benefit under enhanced competition. The dominant market positions of the publicly owned firms demand special attention in their quality of corporate governance as these players can still influence the outcomes of a liberalized industry.

As competition in the markets increases, more entrepreneurs are investing in businesses. Regardless of their size of investment, shareholders must be treated equally and each shareholder deserves protection from any potential embezzlement of their funds by the executives or any other parties (OECD, 1998). This can be achieved through sufficient regulatory and legal back up. Governments can set up regulatory agencies whose principal responsibility would be monitoring the firms' business or corporate behaviours and make corrective interventions whenever the conducts of executives or large shareholders work against the interest of general stock and stake holders. For publicly traded companies, example of such regulatory agency is Securities and Exchange Commission. For financial institutions this regulatory job is usually carried out by central banks. So while governments open up competition in their markets, they must also take necessary steps to set up and strengthen regulatory agencies such as Securities and Exchange Commission (SEC) or Central Bank with appropriate legal back up.

Other than the regulatory and legal back up, the second mechanism through which the rights of share holders can be upheld is the 'market' mechanism. In countries where there is a market for corporate control, hostile takeover has emerged as a particular mechanism for consolidating ownership (Jensen and Ruback, 1983 and Franks and Mayer, 1990). Martin and McConnell (1991) argues that the managers of the poor performing firm will be replaced by more efficient management after the takeover process is completed. Hart (1983) claims that capital market competition provides discipline for manager via takeover mechanism in capital market particularly when firms' environments are interdependent. In US, the series of takeovers in late 1980s have changed the attitude of the US managers support the argument that takeover as the most effective check on management autonomy ever devised which breathed new life into public corporations (Rappaport, 1990). Jensen and Ruback (1983) argued that takeovers typically increase the combined value of the target and acquiring firm, which indicates that profits are expected to increase later.

However there are criticisms as to how effective takeovers are in solving the corporate governance related problems. Herzel and Shepro (1990) suggested that takeovers are very expensive and imprecise solutions to the governance problems. Shleifer and Summers (1988) criticised takeover from a social perspective and said takeovers destroy valuable corporate cultures, which lead to serious allocative consequences. But for takeovers to occur and thus correct corporate governance problems, a liquid market for corporate control or in other words an active capital market is required. Shliefer and Vishny (1997) argue that takeovers are so costly that only significant large performance failures are likely to be focused on. Grossman and Hart (1980) argues that target firm's shareholders will continue to hold their shares if the bidding firm does not pay them for the expected increase in profit under the bidder's management with the hope that shares would become more valuable once the takeover succeed. Most of the developing countries do not have strong, active and liquid stock markets while many of them do not have any stock market at all. For its potential of limiting agency problems through take over mechanisms, policy makers attempts to strengthen active capital markets while deregulating the markets.

In a deregulated era, enhanced competition envisages the growth of new businesses in developing economies which necessitates the need for an enhanced supply of funds either through banks or capital markets. Banking institutions are playing a dominant role in financing businesses in the developing countries in the absence of strong and liquid capital markets. However, most of the banking institutions in developing countries are having the problem of high levels of non performing loans. Also, banks may follow a conservative approach towards financing new businesses due to the perceived risks attached to lending new projects. Since the capital market invests in firms as equity, the risk is relatively lower for the capital market to invest in emerging firms. However, the capital market's interest and active participation in financing new businesses would largely be determined by the fact that how well the rights of investors and shareholders are protected in the markets. The policies on disclosure and incentives are significant in developing appropriate shareholder policies.

Many experts are calling for performance-based incentives in the privatised firms, which could work as a measure to ensure good governance of the firms. Incentives are particularly effective in aligning and motivating the behaviour of those executives who did not face disciplinary actions for job failures and who did not receive anything in addition to their salary for business successes, which could work as their motivations. Many studies have outlined a positive relationship between pay and performance (Murphy 1985, Coughlan & Schmidt 1985). Sometimes attractive incentive packages are used by investors to keep the behaviour of the managers in line with the investors' interest and such incentive contracts can take a variety of forms, including share ownership, stock options, or a threat of dismissal if income is low (Jensen & Meckling 1976, and Fama, 1980). Cash incentives could play a powerful motivating role in boosting the executive morale and

interest within a short period of time as it happens to be liquid and readily available to render benefit. However in the long run incentives through stock remuneration such as stock options may play a more effective role as the benefit flowing to the executives would only increase with the increase in share value of the company which would reflect an overall improvement in a firm's market and financial position. But this is only possible where an active and strong capital market is present. The developing countries in general lack such equity market and as a result cash incentives may be the more effective way of motivating the corporate management of those countries until their capital markets reach a sound and efficient stage. However, the high-powered incentive contracts may enable managers to self deal as well (Shliefer and Vishny, 1997). This may be possible if the managers are dealing with board of directors who represent dispersed small shareholders and posses very low motivation. But it would still be worthwhile to encourage the new firms under deregulated environment to offer performance based pay systems or incentive packages to the executives in order to tackle the governance problems related to efficiency enhancement and competition.

In a pre reform era, the information of firms available to the public domain is very limited, a practice conducive to encourage corruption and hides failures resulting from wrong decision-makings, at least in the short term, which has changed later on as part of the reform process. The implementation of timely disclosure methods and regular auditing of the firms are essential for firms to become efficient, accountable and transparent. The development of capital market may help in this regard as it is a usual practice for listed companies to disclose corporate information through annual reports as well as audit reports.

4. Conclusion

Competition, having gone through different evolutionary stages in past couple of centuries, is now being widely perceived as a force, as a consequence of liberalisation policies, to achieve efficient production and resource allocation. The financial crises in several developing and emerging economies has provided an opportunity to have a better appreciation of corporate governance and its role in national economies particularly in boosting investor confidence, improving the quality of investment decisions and fostering the resiliency of corporate sector. Although there is no one-size-fits-all system of corporate governance, some common features as discussed in the paper are demanding attention in an era of competition. In the wake of rising number of deregulation and privatization-ownership structure and pattern will play a crucial role in steering corporate goals in line with the benefits of the greater spectrum of stock and stakeholders. Along with that the role and contribution of boards, effective monitoring and incentive systems for the managers added with greater transparency in firm activity and decision makings are demanding equal attention in any corner of the world. Addressing these issues through sound policy making and effective regulatory back up would certainly lead to successful consequences of competition through deregulation and privatization in the emerging economies.

Reference

1. Alchian A. A. (1950). 'Uncertainty, Evolution and Economic Theory', Journal of Political Economy, Vol. 58: 211-221
2. Alchian, A. A. and H. Demsetz (1972), 'Production, Information Costs and Economic Organization', American Economic Review, 62(5).
3. Black, B (1990) 'Shareholder Passivity Re-examined', Michigan Law Review, Vol. 89
4. Black, B. (2000). 'Legal and Institutional Preconditions for Strong Securities Markets', Working Paper No. 179, Stanford Law School, Stanford University
5. Blair, M. (1995) 'Ownership and Control: Rethinking Corporate Governance for the Twenty First Century', Brookings Institute, Washington D.C.
6. Berle A. and G. Means (1932). The Modern Corporation and Private Property, New York, World Inc.
7. Clarkson, M.B.E.(1994) 'A Risk-Based Model of Stakeholder Theory', The Centre for Corporate Social Performance and Ethics, University of Toronto.
8. Cook, P (2001), 'Competition and its Regulation: Key Issues', Working Paper no. 2, Centre on Regulation and Competition
9. Corporate Governance (2000). Editorial Article in Corporate Governance , Vol. 8, No. 4, October
10. Coughlan, A and R. Schmidt (1985), 'Executive Compensation, Management Turnover and Firm Performance: An Empirical Investigation', Journal of Accounting and Economics (7), 43-66
11. Glen, J., A. Singh and R. Matthias (1999), 'How Intensive is Competition in the Emerging market? An Analysis of Corporate Rate of Return from Nine Emerging Markets', IMF Working Paper No. 32, Washington DC, International Monetary Fund
12. Grosfeld I and T Tress (2001). 'Competition, Corporate Governance: Substitutes or Complements? Evidence from Warsaw Stock Exchange', Discussion paper No. 2888, Centre for Economic policy Research, London, July.
13. Grossman, S. and O. Hart (1988), 'One Share-One Vote and the market for Corporate Control', Journal of Financial Economics, 20, 175-202

VIRTUS INTERPRESS®

14. Grossman, Sanford and Oliver Hart (1980), 'Takeover Bids, Free Rider Problem and the Theory of Corporation', Bell Journal of Economics, Vol. 11
15. Harris, M. and A. Raviv (1988), 'Corporate Governance: Voting Rights and Majority Rules', Journal of Financial Economics, 20, 203-235
16. Hart O. (1983). 'The Market Mechanism as an Incentive Scheme', Bell Journal of Economics, 14 (2): 366-382
17. Herzel L. and R.W. Shepro (1990). 'Bidders and Targets: Mergers and Acquisitions in the U.S., Blackwell, Oxford
18. Jensen, M.C. (1989). 'Eclipse of Public Corporation', Harvard Business Review, Sept-Oct at 61
19. Jensen, M.C. and W. H. Meckling (1976), 'Theory of the Firm: Mangerial Behaviours, Agency Costs and Ownership Structure', Journal of Financial Economics 3
20. Jensen, Michael and Richard Ruback (1983), 'The Market for Corporate Control: The Scientific Evidence', Journal of Financial Economics, 11.
21. Kang, J and A. Shivdasani (1995), 'Firm performance, Corporate Governance and Top Executive Turnover in Japan', Journal of Financial Economics, 38, 29-58
22. Kaplan, S. and B. Milton (1994), 'Appointment of Outsiders to Japanese Boards: Determinants and Implications for Managers', Journal of Financial Economics, 36, 225-257
23. Kole S. and K. Lehn (1997). 'Deregulation, the Evolution of Corporate Governance Structure, and Survival', The American Economic Review, Vol. 87 (2) 421-425
24. Learmount, S (2002) "Theorizing Corporate Governance: New Organizational Alternatives", ESRC Centre for Business Research, University of Cambridge Working Paper no. 237
25. Mace, M. (1971). Directors- Myth and Reality: Boston: Division of Research, Harvard Business School
26. Martin, Kenneth and John McConnell (1991), 'Corporate Performance, Corporate Takeovers and Management Turnover', Journal of Finance, Vol. 46
27. Monks, R.A. and N. Minnow (1995), Corporate Governance, Blackwell
28. Murphy, K.J. (1985), 'Corporate Performance and Managerial Remuneration: An Empirical Analysis', Journal of Accounting and Economics (7), 11-41
29. Shivdasani, A. (1993), 'Board Composition, Ownership Structure and Hostile Takeovers', Journal of Accounting and Economics, 16, 167-198
30. Shleifer, A. and L. Summers (1988), 'Breach of Trust in Hostile Takeovers', in A.J. Auerbach (eds), Corporate Takeovers: Causes and Consequences, University of Chicago Press, Chicago
31. Shleifer, A. and R. Vishny (1997), 'A Survey of Corporate Governance', Journal of Finance, 52(2), 737-83
32. Stiglitz, J. (1999). 'Quis Custodiet Ipsos Custodes? Corporate Governance Failures in the Transition', ABCDE Conference; Paris; World Bank
33. Turnbull, S (1997)"Corporate Governance: Its Scopes, Concerns and Theories", Corporate Governance, Vol. 5, No. 4