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From Sustainable Companies to Sustainable Economies: Corporate Governance as a Transformational Development Tool

Paper at a glance

- Corporate governance is an effective transformational development tool, helping countries improve both private and public governance institutions.
- Institutions required for a functional corporate governance framework are the ones that are key for democratic governance and market reforms.
- Corporate governance is applicable beyond listed companies – it is relevant for small and medium-sized businesses, family firms, state-owned companies, and others.
- Sound corporate governance frameworks benefit companies, industries, and national economies.

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The Center for International Private Enterprise (CIPE) strengthens democracy around the globe through private enterprise and market-oriented reform. CIPE is one of the four core institutes of the National Endowment for Democracy and a non-profit affiliate of the U.S. Chamber of Commerce. Since 1983, CIPE has worked with business leaders, policymakers, and journalists to build the civic institutions vital to a democratic society. CIPE's key program areas include anti-corruption, advocacy, business associations, corporate governance, democratic governance, access to information, the informal sector and property rights, and women and youth.

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Introduction

For democracy to deliver, reform efforts must focus on improving economic institutions as well as political structures. Despite some impressive growth figures, many fragile democracies continue to face pressing economic and social problems of poverty, infrastructure decay, limited access to basic resources, and lack of private sector jobs. The emerging energy and food crises are only exemplifying these problems, resolving which should be on the top of the agenda for everyone involved in development, as unaddressed citizen concerns undermine the legitimacy of governments and lead to reversals from the course of democratic and market reform.

The economic and political landscape of the world has certainly changed over the past several decades. Building on their recent success, whether from export-driven growth or natural resources, emerging markets are set to overtake developed countries in terms of overall economic wealth in the coming decades. Much of the attention to growth and development in emerging economies, however, has been confined to BRIC countries – Brazil, Russia, India, and China. Although not without their own set of problems of unequal income distribution and still poor social conditions, these four countries have certainly redefined the power nexus and are becoming major players in the global arena.

But what about the rest of the developing world? What prospects do smaller countries have going forward? As dozens of other emerging markets outside of BRIC continue to struggle to attract investment, create jobs, and achieve functional democratic governance, the need for working approaches to reform remains pressing. How can the rest of the world address the socio-economic challenges that persist despite an unprecedented rise in the number of electoral democracies over the past several decades?

Of course, there is no one source of and no one answer to the many of the issues facing emerging economies today. In countries exhibiting strong macroeconomic growth, it is not uncommon to see the benefits out of reach for the poor because of the unequal distribution of income and opportunity. In countries struggling to break out and reduce poverty through sustainable economic means, much of the economic activity remains trapped in the informal sector, where entrepreneurial survival rather than business growth and development best describes the private sector. Many of the fragile democracies exhibit governments that are seldom accountable to their citizens beyond elections. In such countries, day-to-day decision-making processes remain opaque, unpredictable, and impenetrable for outsiders, while economic systems are being tailored to benefit the insiders.

Corporate governance is a viable solution to many of these problems. Traditionally, it has been viewed as the domain of large companies in developing economies – something of interest to investors and CEOs. However, as experiences of the past several decades show, corporate governance is much more than that. It helps to clean up the governance environment, exposing insider relationship and injecting values of transparency and accountability in both private and public transactions. Corporate governance is also an effective means of building up a functional small and medium-sized enterprise sector which can be capable of generating jobs and attracting investment – recognized sustainable solutions to poverty. In all, as good governance in the private sector is inseparable from good governance in the public sector, corporate governance can be viewed as one of the important tools to make democracies deliver for all segments of society. This paper explores these linkages in more detail.

Reducing Poverty: The New Global Development Agenda

The eight Millennium Development Goals (MDGs), outlined in the United Nations Millennium Declaration in 2000 and embraced by governments, civil society, international institutions, and the private sector in countries around the world, have fundamentally changed the global perception of development. MDGs have brought poverty and inferior socio-economic conditions to the forefront of the development agenda and created a new vision of

the world where people at all levels of society benefit from economic growth.

Although building consensus on MDGs has been a monumental accomplishment in its own right, signatories continue to face much greater challenges in actually achieving these goals – according to some UN studies, progress has not been uniform. Despite increased attention and financial commitments, billions of people still live on less than $2 a day, and many lack access to the most basic public services taken for granted in developed countries. While MDGs have been successful in drawing the world's attention to these problems, the framework outlined in the UN Millennium Declaration has left the field wide open as to which strategies should be implemented to achieve poverty alleviation and to facilitate the development of more prosperous societies.

Building market economies, unleashing entrepreneurship, strengthening governance, promoting investment, securing property rights, and combating corruption are some of the reform priorities that have been identified as key to reducing poverty and moving countries up the development ladder. The UN's own "Unleashing Entrepreneurship" report and the Monterrey Consensus are just two of the many initiatives that have succinctly captured reform issues that countries must address to reduce poverty. Countries' own institutional deficiencies, however, remain a real barrier to implementing many of these recommendations.

Despite notable successes in reducing poverty in some places, we often find that foreign aid does not reach its intended recipients. Corruption continues to rob the poor while anti-corruption programs stall in red tape and bureaucracy. Elites enjoy access to the benefits of trade and investment while regular citizens are left out. Entrepreneurs are forced to operate in the informal sector without access to legal mechanisms to enforce contracts and protect private property. Public funds devoted to building infrastructure and providing public services end up in the pockets of crooked government officials and their cronies. Jobs are not being created to accommodate the burgeoning youth population.

Ultimately, to reduce poverty, reformers must attack the very causes of it – weak institutions that squander resources, undermine fair competition, reward corrupt behavior, and restrict private sector development and job creation. What mechanisms do we have to promote institutional reform? How can we

Monterrey Consensus

In March 2002, 50 heads of state or government, over 200 minister and leaders from the private sector, civil society and all the major intergovernmental financial, trade, economic, and monetary organizations participated in the International Conference on Financing for Development in Monterrey, Mexico. The conference adopted the Monterrey Consensus, which maps out a strategy for addressing poverty and other most pressing problems facing countries around the world.

"Our goal is to eradicate poverty, achieve sustained economic growth, and promote sustainable development as we advance to a fully inclusive and equitable global economic system."

Leading Actions:

- Mobilizing domestic financial resources for development
- Mobilizing international resources for development: foreign direct investment and other private flows
- International trade as an engine for development
- Increasing international financial and technical cooperation for development
- External debt
- Addressing systemic issues: enhancing the coherence and consistency of the international monetary, financial, and trading systems in support of development

Throughout the many initiatives captured within these categories, the Monterrey Consensus outlines how democratic governance and market economies can help to reduce poverty around the world. Focusing on the role of the private sector and economic solutions to poverty, the Monterrey Consensus is a fundamentally important document that captures world leaders' commitment to sustainable poverty reduction strategies.

For more, visit:
www.un.org/esa/sustdev/documents/Monterrey_Consensus.htm

Key Points

- Corporate governance has a much broader application than improving internal company procedures, important in their own right. Corporate governance encompasses a wide variety of tools that also address the environment within which companies operate – i.e. issues associated with the institutional development of countries.

- In addition to attracting investment, improving competitiveness, and managing risks, corporate governance is fundamental to changing the relationship between business and state in many emerging markets. By injecting transparency into the equation, corporate governance helps to remove cronyism, corporatism, and favoritism, instead facilitating an open exchange between the private sector and government.

- By helping countries to attract investment, facilitating institutional reform, reducing opportunities for corruption, increasing competitiveness, and promoting minority shareholders rights protection, corporate governance helps to build a foundation for economic growth, job creation, and private sector-led poverty alleviation.

- There are two types of drivers of corporate governance reform. One set of drivers is associated with failures and collapses. A more proactive set of drivers has much to do with companies' and countries' search for investment, the need to improve competitiveness, and gaining access to regional and international markets. Both have been responsible for increased attention paid to corporate governance over the past decade.

- Corporate governance is applicable to a wide variety of companies, not just large multinationals listed on major stock exchanges. As a means of introducing transparency, accountability, responsibility, and fairness in company decision-making structures, various corporate governance mechanisms can benefit many different companies – including SMEs and family-owned firms not listed on stock exchanges – seeking to build sustainability and remain competitive.

- In many emerging markets, the emphasis must be placed on the enforcement of the existing corporate governance mechanisms. While developing new tools is important, reformers must pay closer attention to the already existing mechanisms and seek ways to ensure that they are consistently implemented and enforced for all market players.

- Although the debate continues on voluntary vs. mandatory systems of corporate governance, reformers must seek to integrate the business community in the process of developing corporate governance mechanisms in either one of the systems. Getting the business community engaged in the process early creates a sense of ownership and provides ample opportunities for valuable feedback and effective implementation.

- Ultimately, the creation of corporate governance value systems combined with the strengthening of basic rights and legal institutions contribute to the development of stable and democratic societies.

move people up from the bottom of the development pyramid? How can the power of the private sector be best utilized to reduce poverty and improve living standards? These are the questions that countries and the development community continue to answer as the deadline for achieving MDGs quickly approaches.

Corporate Governance as a Development Tool

At a first glance, corporate governance may seem like an odd answer to the questions outlined above. After all, the popular perception of corporate governance is that it is something more applicable to multinational corporations, large stock exchanges, and CEOs rather than average entrepreneurs, SME loans, and job creation. Corporate governance is frequently discussed in the context of complex accounting procedures and disclosure mechanisms and certainly not in the context of poverty alleviation. Yet, a closer look at corporate governance, its broader application, and, most importantly, its institutional underpinnings, underscores its role as an essential component of public governance and private sector development, both of which are recognized poverty alleviation solutions. This paper uncovers some of these linkages.

Values of Corporate Governance

Transparency, responsibility, accountability, and fairness – these four concepts are now widely quoted as the key principles of good corporate governance.

The original definition of corporate governance, outlined above, is built around the concept of accountability. It stems from the belief that owners entrust the managers with running their company and they can hold them accountable for any violations of the contract. Accountability, in that sense, requires the functioning of supporting institutions, both internal and external.

When we speak of transparency in a corporate setting, we focus on the timely and proactive disclosure of financial and other information to shareholders. Such disclosure can be voluntary or mandatory depending on the market and legal environment within which companies operate.

In the corporate governance framework, fairness ensures equitable treatment of minority shareholders, employees, managers, and other agents. Rules and mechanisms of good governance in the private sector seek to eliminate discrimination and establish a clear, predictable environment conducive to long-term investment planning.

The concept of responsibility deals with the integrity of markets and citizen's trust in market institutions and corporations. Responsibility has both internal (owners-managers-employees) and external (business-society) application in the business environment.

The conventional view of corporate governance has much to do with separation of ownership and control – issues that arise between owners and managers of corporations. Managers and owners, the theory holds, may have different interests, and fully removed from managing the day-to-day activities of the enterprise, owners need guarantees that managers act in the interest of a company (or its owners) rather than in their own interest. This is where corporate governance comes in – it establishes the mechanisms necessary to ensure proper actions on behalf of managers of a corporation. For example, it helps prevent theft of property or its misuse by management.

From this simple concept, corporate governance extends into many areas of creating sustainable business. How do boards of directors actually function? What is the role of the board of directors? How do you define the rights of stakeholders? What mechanisms are available to prevent the abuse of minority shareholders' rights? What are the key disclosure mechanisms and which areas of company operations should not be disclosed to the general public?

But such a narrow view of corporate governance – as a tool only useful for large corporations, with many shareholders and powerful managers, listed on stock exchanges in developed countries – is increasingly questioned by reformers and business communities around the world. Weak corporate governance, for example, has been linked to the inability of countries to attract investment, financial collapses, persistent

Corporate Governance Impact

Corporate governance:

- Brings stability to markets
- Strengthens competitiveness (companies and economies)
- Strengthens institutions
- Improves risk mitigation
- Promotes investment, lowers cost of capital
- Weakens corruption
- Strengthens lending
- Promotes reform of state-owned enterprises
- Promotes successful privatization
- Builds transparent relationships between business and state
- Helps to combat poverty

corruption, failures of privatization, weak property rights, and many other development challenges countries around the world face. As such, many economies are warming up to the idea that good corporate governance is essential to their overall health. Companies are beginning to look at corporate governance as something that can give them a competitive edge. The challenge remains, however, in channeling this increased attention into reforms that actually improve governance practices.

What Is Corporate Governance: Defining the Framework

The broader applicability of corporate governance is captured well in the chart on page 6. This World Bank chart illustrates both internal and external mechanisms that make up an effective corporate governance framework. The traditional structure of corporate governance captured on the left side of the chart addresses conventional issues: the relationship among shareholders and between shareholders and the board of directors, the relationship between the board and managers, board composition procedures, management operation, etc. All these different parts, important in their own right, make up the internal, or governance, function of a corporation.

Within a company, whether publicly-held or not, corporate governance provides directors the tools they need to ensure efficiency, accountability, and sound decision-making. Strengthened reporting requirements demand improved accounting procedures and stronger internal control systems, which in turn provide managers and directors the tools they need to control expenditure and gauge revenue. By increasing the transparency, quality, and regularity of financial reporting, managers can be held more accountable for the decisions they make and the performance that results. Poor performance or activities that divert company resources into non-profitable activity can be quickly identified and remedied.

The increased accountability of corporate directors through the duties of care and loyalty required by good governance means that strategic decisions affecting performance and risk are made with greater care and consideration for owners. What duty of care and duty of loyalty mean is that directors should make best-informed decisions in the interest of a company. As seen in recent years, the markets, shareholders, and regulators have increased their scrutiny of director performance, creating demand for qualified directors and institutions that can provide them with training, information, and networking opportunities.

Boards themselves are becoming more sophisticated in the way they control risk factors with independent audit and executive compensation committees becoming commonplace, and board composition increasingly turning to the appointment of independent directors to ensure transparency and accountable decision-making. In many emerging markets, however, the integrity of independent directors often comes into question, as their decisions may still be influenced by dominant shareholders. Yet, these newly effective boards drive internal reforms that enhance efficiency, control risk, and represent shareholder interests more fairly.

Much more important for developing countries, albeit for a long time not recognized as such, is the right side of the chart that captures the external mechanisms that help complete the corporate

governance framework. Broadly speaking, both the private side and regulatory side make up what can be called an *institutional framework* within which corporate governance is implemented. Just as this institutional framework affects corporate governance mechanisms and its enforcement, at the same time, it is itself influenced by corporate governance.

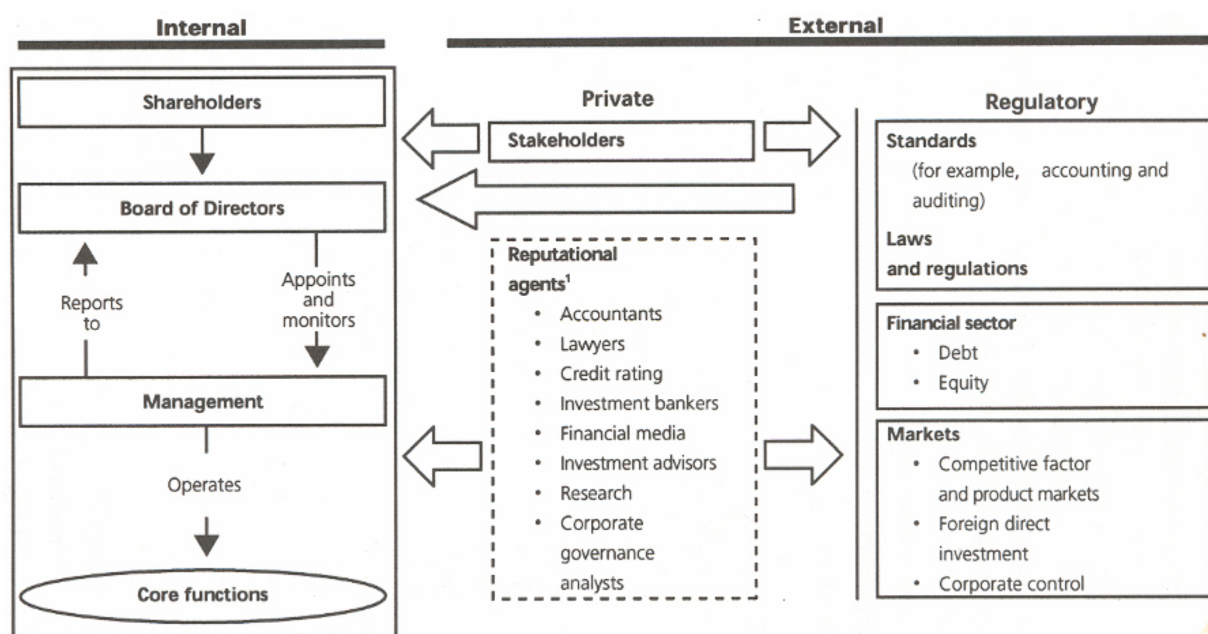
This circular relationship between internal company practices and the institutional environment within which companies operate has not always been recognized. In trying to strengthen corporate governance in emerging markets, many efforts in the past focused on the left side of the chart – building up internal company practices. However, as it has become evident over the last decade, internal company practices are inseparable from the environment within which these companies operate. And while institutions in developed economies are often in place and functional, they are weak or missing altogether in many of the emerging markets seeking to improve governance within the private sector. Addressing these institutional deficiencies along with internal company practices is crucial to the success of corporate governance reforms.

How does this relationship between institutions and intra-company governance mechanisms work? How does corporate governance strengthen institutions?

Corporate governance regulation and enforcement relies on the development of an inter-related web of public and private institutions, regulations and rights that underpin the four basic values of corporate governance – transparency, accountability, fairness, and responsibility. Without the guarantee of these institutions, the market-building benefits of good internal corporate governance become tenuous. However, if functioning well, their benefits have far-reaching impact, increasing investor confidence and providing business the legal basis needed to take risk and to grow.

At its most basic level, a well-developed corporate governance system ensures the rule of law is applied to all companies and that the property rights of shareholders, and the broader rights of other stakeholders (lenders, suppliers, and employees, etc.) are defined and protected. The foundation of these protections is a well-functioning court system capable

Mapping a Corporate Governance System



1. *Reputational agents* refer to private sector agents, self-regulating bodies, the media, and civic society that reduce information asymmetry, improve the monitoring of firms, and shed light on opportunistic behavior.

Source: The World Bank

of adjudicating commercial law as well as exercising true independence in the protection of property rights.

Building on this foundation are a variety of public and private institutions that define corporate governance practice and enforce its implementation. Stock exchanges, through their listing requirements, and securities markets, with regulators and enforcement actions, form the front line of external control. These institutions also guarantee property rights through providing share owners an efficient exit mechanism from ownership, an important element in attracting investment.

This frontline is backed by a group of secondary private institutions such as shareholder rights organizations, corporate governance institutes, and directors' associations, which help build the infrastructure for advocacy, professional standards, and self-regulation. These organizations not only serve to build skills, but are the breeding grounds for new values systems that can help transform corporate behavior and performance.

Ultimately, the creation of these value systems, combined with the strengthening of basic rights and legal institutions, contribute to the development of stable and democratic societies. Good corporate governance requires sound public governance, viable civil society, and an active and independent media which can monitor boardroom actions. By extension ,it requires good corporate citizenship on behalf of companies who must respond to the broader concerns of their stakeholder community, and operate in a responsible and transparent fashion. Moreover, the same values described above – transparency, accountability, responsibility, and fairness – also underpin democracies, and by strengthening corporate governance one also provides tools to make democracies work.

For countries where the institutions described above do not exist or are weak, corporate governance provides an avenue for bringing institutional reform issues to the forefront and to begin addressing them. It should be noted that even in systems that possess weak external institutions, strong internal corporate governance provides value for companies and is worth pursuing as end in itself. Academic research has indicated that investors in high-risk emerging markets with poor public governance, will pay a higher premium to invest in well-governed companies that offer improved financial information as well as better protection for minority shareholders.

Corporate Governance Application in Emerging Markets

As noted above, corporate governance is applicable to all companies, not just large multinationals. The principal-agent problem, that lies at the core of governance issues, is present not only in large corporations (managers acting or not acting in the interest of shareholders) – its also present in any type of a business entity where owners are not the ones managing an enterprise. Simply put, corporate governance can help to ensure that agents (managers) act in the best interest of principals (owners) regardless of the size of the company.

Family firms

Corporate governance is also applicable to family firms, which are prevalent in Asia and the Middle East

Corporate Governance Programs in Emerging Markets: Areas of Interest

- Developing corporate governance codes
- Corporate governance application (companies, family owned firms, SOEs, cooperatives, etc.)
- Stock exchanges
- Company laws/commercial framework
- Financial services
- Training directors
- Shareholders' rights protection
- Tax laws and other areas of legal reform
- Business ethics and codes of conduct
- Property rights and privatization
- Institutional reform
- SOE reform
- Transparency and public procurement

How Does Corporate Governance Affect Development?

- Increased access to external financing by firms, which can lead to greater investment, higher growth, and more employment creation.
- Lower cost of capital and associated higher firm valuation, which makes more investments attractive to investors and leads to growth and employment.
- Better operational performance, through better allocation of resources and better management, which creates wealth.
- Reduced risk of financial crises, a particularly important effect, as financial crises can impose large economic and social costs.
- Better relationships with all stakeholders, which helps improve social and labor relationships and areas such as environmental protection.

Source: Stijn Claessens "Corporate Governance and Development" Global Corporate Governance Forum Focus I Publication, www.gcgf.org

and North Africa region, as well as in Latin America. While family firms are not traditionally associated with governance failures within a conventional model because owners and managers are one and the same, governance issues in family firms are proving to be of major concern in issues of attracting investment and ensuring sustainability in the second and their generation of owners. For example, without clarified rules for management and decision-making, how can you resolve disputes among different owners in the second and third generations, when their numbers can multiply significantly? How can you assure investors that mechanisms are in place to ensure that their funds are spent efficiently on the needs of a company and not on the personal needs of the family-owner? Studies have shown that better governance standards *do* improve sustainability and financial performance of family firms over time.

State-owned enterprises

Corporate governance is also important for state-owned enterprises (SOEs). Not only do good governance practices increase productivity in and competitiveness of SOEs, they also help to ensure that public funds invested in these enterprises are not mismanaged and are spent effectively. By creating more transparent and economically viable SOEs, corporate governance also helps to ensure that services are actually delivered to the public. Further, as state enterprises often provide a bulk of employment in some emerging markets and a variety of essential public services, good governance helps to prevent failures with devastating social impact. In many countries, corporate governance has been used as a means of not only improving the efficiency of SOEs, but also as a mechanism to improve their attractiveness to investors, thus increasing state income from privatization.

In many developing countries, state-owned enterprises make up a disproportionate segment of the economy and suffer from a myriad of management and performance issues that limit their effectiveness and the role they are expected to play in generating growth. Often, these enterprises are found in "strategic sectors" such as infrastructure or trade, where their inefficiencies limit the private sector's ability to contribute to economic development. Working with unclear strategies and multiple lines of accountability, manager decision-making within SOEs becomes hostage to politics and conflicting bureaucratic interests, resulting in a situation where multiple agencies and ministries vie to influence SOE management while ultimate accountability for decision-making is non-existent. By their non-transparent nature, SOEs are often plagued by political patronage, corruption, and waste, which limits their ability to modernize and build responsive and efficient programs of work.

Corporate governance in the SOE sector focuses first and foremost on making the state an effective owner, by establishing clear and simple lines of political and social accountability, improving board selection and quality, and contributing to the development of clear corporate strategies that reward efficiency and professionalism. By improving transparency, internal controls, and reporting, corporate governance practices reduce corruption and self-dealing.

Corporate Governance in Family-Owned Firms

Governance risks in family-owned firms

- Imbalance between the growth of the company's profitability and family growth: the geometric increase of family size and the family's needs in relation to the company may compromise growth and investment in projects that are crucial for the long-term success of the organization.
- Transition between generations and succession plan: the replacement of leadership and the entry of new generations into family-controlled companies is a critical moment, creating situations which may generate internal conflicts and a decrease in management quality.
- Separation of interests between company and family: the discussion of family affairs in the company (and vice versa) and the lack of criteria in the separation between family and corporate assets may be harmful to the organization.
- Maintenance of professionalism under certain situations: long-term family dynamics (personal relationships and the emotional history involved) could influence business-related decisions. Additionally, it may be harder to exercise authority and market practices among relatives.
- Nepotism: the automatic promotion of an individual based on family relationships may undermine meritocracy in the work environment, causing the flight of talented personnel and an increase in personal rivalry between members of top management.
- Rivalry between generations and siblings: the coexistence of different generations in the same company may bring about disputes for self-assertion and power. Additionally, an attempt on the part of different partners to promote their respective family-branch or the influence of in-laws, coming into play as time goes by, may have negative impacts on the company.

Benefits of good corporate governance in family-owned firms

- Increased professionalization in company management
- Higher degree of formalization of the work processes
- Improvement of the decision-making process of top management
- Clearer separation of roles between representatives of the ownership (directors) and of management (chief executive officer and other executives)
- Better management of the risks associated with the investment and improvement of internal controls
- Increased ability to attract and retain talented personnel
- Admission of independent board members and their active participation in committees
- Better criteria for the evaluation of performance and for a system of compensation for executives (establishment of measurement of added value)
- Development of better accounting practices and managerial instruments
- Better perception of the corporate roles by the investors
- Increased access to capital
- Increase in liquidity and volume of shares traded
- Possibility of wider diversification of assets by the controlling shareholders
- Greater precision in share-pricing
- Increase in the number of international issuances for the raising of funds, mostly through debt securities

Source: Brazilian Institute of Corporate Governance (IBGC) "Corporate Governance in Family-controlled Companies: Outstanding Cases in Brazil." The findings are part of the study of corporate governance practices of 15 largest family-owned firms in Brazil.

By introducing good governance values to the state-owned sector, corporate governance creates clear lines of accountability that directs the state's ownership role through a single state ownership bureau that translates the political and social demands of state ownership to a qualified board of directors. In turn, this independent board translates policy into strategic decision-making that guides management responsible for implementation.

Lines of accountability for SOEs thus become clearer and easier to track to their policy roots in government and ultimately to the voter, who makes the ultimate performance determination during elections. By using corporate governance to strengthen lines of accountability and performance, companies not only improve governance – they also improve incentives for democracy to function.

SMEs and the financial sector

Within the framework of economic development, access to credit is often cited as one of the biggest challenges facing private enterprise, especially in economies where capital markets are underdeveloped and banks serve as a key source of capital for growing businesses. However, local banks often are a poor source of affordable credit, and they themselves can be sources of economic risk, as was evident during the Russian financial crisis of 1998. Insider lending, often leading to default, is a major source of risk in many emerging markets where weak legal frameworks and poor central bank oversight allow bad loans to be made. When this is combined with a business community where poor governance practices at the company level serve to hide the true financial condition of loan recipients, risk levels often drive interest rates to unattainable levels.

As such, in many emerging markets, corporate governance has the potential of being an effective risk mitigation tool in the financial sector. Basel II guidelines, for example, have pushed for a more responsible behavior by banks in order to increase preparedness for failures and to ensure proper evaluation of risks. Yet, the same guidelines fall short of identifying the mechanisms for achieving these goals. Corporate governance, in this regard, fills the void and can be viewed as an effective tool to strengthen banks' stability and profitability and, more importantly, it can be used to successfully evaluate the risk of failure in making loan decisions. By requiring better financial information from companies before making loans, banks can encourage the adoption of sound accounting systems and regular reporting even in economies dominated by family-owned and closely-held companies. In this light, the banking sector can promote good governance in economies where companies do not naturally rely on stock exchanges to raise capital.

In addition, corporate governance plays an important role in state-owned or -dominated banks by helping to ensure that economic decision-making trumps political considerations in extending loans. This process works similarly as described above for SMEs – more transparency and accountability in board composition, decision-making, and disclosure forces banks to put economic considerations above political favors.

Within banks, improved board governance starts through greater transparency in loan decision-making, wherein directors and related parties must disclose lending relationships. In other words, high-risk insider lending can be contained through duty of care and loyalty. Extending the concept of risk management through board guidance and better supervision of management lending practices, potential loss-making and insider lending can be curtailed, thus improving overall loan performance and reducing the cost of credit.

As a result, corporate governance promoted within and through the banking system can contribute to economic stability through better bank oversight, as well as improve risk management and drive down the cost of capital – thereby generating growth.

Transforming Business-State Relations

Corporate governance plays an important role in transforming business and state relations. As financial crises in Asia and Russia have shown, a murky relationship between government officials and some private sector companies can undermine economies and lead to economic collapse. The lack of transparency in business-state interactions often leads to preferential legal and regulatory treatment, asset stripping, waste of resources, and corruption that undermines the competitiveness of national economies while benefiting a few insiders. Corporate governance helps to address these problems and is an effective solution to corporatism, cronyism, and favoritism.

Privatization is a good example of this effect. Within SOEs scheduled for privatization, for example, introducing good corporate governance can play an important role in preparing companies for the new challenges brought about by private ownership. When examining the legacy of privatization in transition economies during the 1990s, much of the corruption, shareholder abuse, and self-dealing that resulted can be directly tied to the failure of the state to establish and require effective governance mechanisms within privatizing firms. Asset stripping, share dilution, and the "tunneling" of capital by owner/managers were features of the "wild west capitalism" which afflicted many former communist economies and did much to discredit early popular notions of capitalism and democracy. Corporate governance therefore has a crucial role to play not only in readying firms for privatization, but in preventing the potential market mayhem that can occur when firms privatize without effective internal controls, reporting mechanisms, and shareholder protections.

Instituting sound internal corporate governance measures into state-owned firms prior to privatization is crucial to ensuring a smooth transition to private ownership both prior to and after the privatization process. Good internal accounting and controls contribute to effective evaluation and can enhance value by reducing investor costs associated with transitioning accounting practices and building internal control systems. Establishing a model of board governance and management accountability prior to privatization also facilitates a smooth transition to private ownership/governance models.

In cases of voucher or IPO forms of privatization, good corporate governance is important in balancing shareholder expectations and rights with the needs of majority owners seeking to restructure and reorganize firms. Additionally, improved transparency and good board/stakeholder relations help negotiate conflicts that may occur as a result of these efforts. The values of fairness, accountability, responsibility, and trust that are hallmarks of good corporate governance are central to developing privatization models that assure value, ease the privatization transaction, protect stakeholder and shareholder interests, and allow for more efficient post-privatization restructuring.

Corporate Governance as an Anti-corruption Tool

No longer silently accepted or regarded as a taboo in many developing countries, corruption has emerged as one of the bigger barriers to democratic development and economic growth. Linkages between high corruption levels and bad governance, as well as higher poverty, higher inequality, and poor public services are rarely questioned. In all, from a political perspective, corruption destabilizes political institutions and leads citizens to question the legitimacy of democratic institutions marred by bribery and extortion. From an economic perspective, corruption leads to lower investment levels, a larger informal sector, higher costs of doing business, and uncertainty in contracting.

Consider the typical corruption dilemma from the private sector view point – although corruption is bad for business, individual companies that engage in corruption receive a short-term advantage. Taking into the account the damaging effects of corruption on the overall economic health of an economy, the question becomes, 'How do you set up a system that makes it hard for companies to engage in corruption, even if corruption seems desirable for those individual companies?' What the issue really is here is solving a collective action problem – shaping incentive structures in a way that the private sector commits to responsible business practices, exposes corrupt behavior, and does not allow corruption to become part of doing business.

The reforms to do just that can come from many different directions. On the government side, we can introduce checks and balances systems, reform procurement codes, implement independent audits, engage in legal reform, simplify tax codes, make use of e-government systems, and concentrate on enforcement of existing rules and regulations. Yet, there are reforms we can also implement on the part of the private sector, limiting, as outlined above, its ability to engage in corruption.

One such reform is corporate governance. Consistent with the view of corruption outlined

CIPE Strategy for Corporate Governance Reform

1. Initial Assessment

a. Assess corporate governance failures, challenges, opportunities, etc.

b. Rate country standards vs. international best practices

c. OECD principles/guidelines and local realities

2. Outreach and Education

a. Identify stakeholders

b. Build awareness: business leaders, policymakers, society

c. Create broader public demand for reform

d. Public education campaigns

3. Develop and Institute Corporate Governance Mechanisms

a. Develop corporate governance codes and internal control mechanisms

b. Foster shareholder activism

c. Improve regulatory and enforcement frameworks

d. Create corporate governance networks including regulatory bodies, business leaders and organizations, and other civil society groups

4. Capacity-Building, Enforcement, and Follow-up

a. Training and certification programs for managers and directors

b. Establishment of Institutes of Directors

c. Create corporate governance ratings systems for investors

d. Training for financial intermediaries

e. Broader legal and institutional enforcement: ex. judicial systems

above, corporate governance reduces the number of corruption opportunities by making bribery harder to conceal, positioning it not only as an immoral but also illegal behavior with personal costs to those who provide bribes, and outlining internal penalties for violation. Effective corporate governance means that transparency values are present, investors receive timely and relevant information, decision-making is not done behind closed doors, decision-makers are held accountable for their actions, and managers act in the interest of a company – not their personal interests. The bottom line is that effective corporate governance makes it hard for companies to provide bribes or other company resources to government officials in exchange for services.

As a corruption-fighting tool, corporate governance reduces the scope for corporate employees and directors to engage in self-dealing and or corrupt practices with public and private counterparts on a number of levels. On the level of values, corporate governance's focus on a director's duty of care and loyalty rule out self-dealing and provide sanctions for directors who place their own personal interest and gain above those of the company.

On a more practical level, tightened internal controls and financial reporting allow managers and directors to ensure that transactions with suppliers and vendors, as well as dealings with government officials, remain above board and free of corruption and self-dealing.

The role of the independent director as prescribed by good governance standards also reduces the probability of self-dealing through peer scrutiny. This can be reinforced through independent director participation in the board audit committee, which provides an independent guarantee of an audit's credibility.

One example is the Business Principles for Countering Bribery (BPCB) developed by Transparency International with the help of business leaders and NGOs. The principles address political and philanthropic contributions, gifts, hospitality, and even facilitation payments, the topic that has generated some heated debates in regards to corruption. Implementing the principles requires that boards of directors take formal responsibility for their actions, effective whistle-blowing channels exist, internal control measures are embedded in decision-making, formal accounting procedures set up that check for bribery, and there is internal communication and training.

Conclusion

The broader view of corporate governance, as a set of mechanisms that deals with institutional reform and not just company-level changes, suggests that it is one of the integral components of successful development strategies. Corporate governance is fundamentally central to building competitive economies, reducing the private sector side of corruption, promoting property rights, and creating jobs and wealth – all of which are components of successful poverty alleviation efforts. The development community must take a closer look at how corporate governance can be used as a tool to improve public governance and promote democratic and market-oriented reforms.

Ultimately, however, efforts to promote corporate governance must take into the account the drivers of reforms – both positive and negative. On the negative side, drivers of corporate governance are most frequently associated with financial failures and corporate scandals. This set of drivers suggests a reactive approach to corporate governance reform. A more proactive approach is associated with positive drivers, which include search of investment, increased competitiveness, and efforts to combat corruption. Seen in this light, corporate governance can be used as a tool to spur broad-based reforms in the areas of investment and company laws, property rights protection, enforcement mechanisms, accounting and tax laws, Judicial reform, and others.

While the international community has many different corporate governance tools ready for implementation, reformers must avoid the temptation of copying successful initiatives from elsewhere. In the end of the day, successful institutional reforms require building local capacity and commitment to reform efforts, not transferring policies from one set of books to another. Seeking access to capital and entry into global markets, the private sector in many emerging markets can become a true leader in corporate governance reform, allowing the benefits of transparency, responsibility, fairness, and accountability to spread across society and help millions to escape poverty.