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Corporate Governance Challenges in Emerging Economies*

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Introduction

Corporate governance research in the context of emerging economies has received increasing attention in recent years (Al-Malkawi, Pillai & Bhatti, 2014; Allen, 2005; Berglöf & Claessens, 2006; Black, Gledson de Carvalho, Khanna, Kim & Yurtoglu, 2014; Claessens & Fan, 2002; Claessens & Yortuglu, 2013; Crittenden & Crittenden, 2012; Fan, Wei & Xu, 2011). Academics and practitioners are becoming aware that the nature of governance problems and the firm-level governance mechanisms at work in different countries are embedded in their own national business system and influenced by political, social and legal macro-institutions (e.g., Aguilera, Filatotchev, Gospel & Jackson, 2008; Filatotchev, Jackson & Nakajima, 2013; Peng, Wang & Jiang, 2008). More specifically, governance problems in developed economies tend to have their roots in dispersed ownership, small managerial shareholdings, prevalence of standalone companies, and market-based transactions. However, emerging economies are characterized by concentrated ownership, pyramidal ownership structures, dominance of business groups, and high levels of related-party transactions. As a consequence, principal-principal conflicts are a major concern of corporate governance in developing countries (Young, Peng, Ahlstrom, Bruton & Jiang, 2008). In addition, emerging markets are often subject to weaker formal institutions and different informal institutions; and these country-level institutions tend to have important implications on corporate governance arrangements and their effectiveness (Hou, Kuo & Lee, 2014; Kumar & Zattoni, 2013 and 2016).

To carry forward the success of the special issue on "Asian Corporate Governance" (Li & Nair, 2009) and to further advance understanding of the relevant issues, the University of Edinburgh Business School hosted a special issue conference on "Challenges in Corporate Governance in Emerging Economies" in conjunction with *Corporate Governance: An International Review* on 4-5 December 2015 in Edinburgh, UK. The keynote speech of the conference was contributed by David Yermack from NYU Stern School of Business. He discussed the corporate governance implications of blockchain technology for emerging countries in terms of improved liquidity and transparency, reduced costs in trading and voting, and reduced needs for auditing and litigation. The conference and the special issue attracted about 70 submissions by scholars from various disciplines and from around the globe. Twelve papers were selected for presentation in the conference. All papers were subjected to the standard refereeing and editorial process of *Corporate Governance: An International Review*. In this article, we introduce peculiarities of corporate governance in emerging economies and survey the four articles that were eventually accepted for inclusion in the special issue.

Peculiarities of Corporate Governance in Emerging Economies

Different Governance Environments

The differences in the nature and the extent of governance problems that we observe between developed and emerging economies imply that firm-level governance solutions that aim to minimize the costs of governance-related efficiency losses are also different (e.g., Zattoni & Judge, 2012). Typically, governance solutions constitute an optimal mix of internal and external mechanisms (e.g., Walsh & Seward, 1990) with the weights differing between developed and emerging economies. Whereas "bundles" of governance mechanisms in developed economies rely more on board monitoring, executive compensation and the market for corporate control, in the relationship-based systems in emerging economies, a greater emphasis is placed on the governance role of lending institutions, large blockholders including family shareholders, and organizational governance hierarchies. In large emerging economies such as China, India and Russia, there is moreover significant involvement of state agencies in running businesses even when some of their shares are publicly listed on the stock exchanges (e.g., Firth, Fung & Rui, 2006; Grosman, Okhmatovskiy & Wright, 2016; Yang, Chi & Young, 2011).

Governance developments in both established and emerging economies also indicate that changes in the economic environment, as well as changes in cultural, political and legal institutions, have a profound impact on the evolution of firm-level governance mechanisms as well as their effectiveness. In general, every country's national governance system is path-dependent (Bebchuk & Roe, 1999). An important implication of such path-dependency, particularly in the context of emerging economies, is that, while regulators and corporate governance activists promote the adoption of international best practices, the differences in formal and informal institutions interact with firm-level governance developments to provide a basis for multi-dimensional, multi-level corporate governance systems that incorporate the evolution of their country-specific institutions.

Research Perspectives

In recent years, a considerable literature has begun to emerge that has challenged the objective of modern corporations itself. Specifically, this literature asks whether governance systems of modern corporations should be focused on maximizing financial returns for the shareholders and stakeholders (including customers, suppliers, employees, community) or should also cover the objectives of society at large, including protecting the environment (Freeman, Wicks & Parmar, 2004; Jones & Felps, 2013; Mitchell, Weaver, Agle, Bailey & Carlson, 2016). Falling under the rubric of 'corporate social responsibility' (CSR), and popularly referred to as the 'environmental, social and governance' (ESG) framework, this view signifies a whole gamut of corporate behaviour, ranging from falling moral standards and ethical practices in business to improving the quality of life of the workforce, protecting human rights, promoting gender diversity, caring for the environment, and meeting broader developmental goals such as alleviation of poverty and inequality (e.g., Campbell, 2007; Carroll, 1999; McWilliams & Siegel, 2001). Notwithstanding the concern by some that CSR might distort managerial incentives due to the presence of multiple objectives and exacerbate governance problems (e.g., Jensen, 2002), there is a growing assertion that socially responsible management that balances the legitimate stakes of internal and external constituencies (Talaulicar, 2010) can lead to higher financial return. This argument makes moot the trade-offs between shareholder objectives and social responsibility and suggests that growth that is sustainable in the long run may be achievable, although the underlying mechanisms driving this relationship may be more complex (Saeidi, Sofian, Saeidi, Saeidi & Saaeidi, 2015; Wang & Choi, 2013; Zhao & Murrell, 2016). CSR has become an important topic in countries across the world but has gained special emphasis in emerging economies because of the complementary role corporations can play in overall development processes to provide collective goods (e.g., Boddewyn & Doh, 2011) and to build institutions (Marquis & Raynard, 2015). The adoption of CSR practices whose effectiveness may also rest on institutional conditions (e.g., Halkos & Skouloudis, 2016) may therefore signal to investors the superior capabilities of firms that can be utilized to fill institutional voids common in developing countries (Su, Peng, Tan & Cheung, 2016; Jayasinghe, 2016).

The nature of the governance problem and the solutions that are characteristic of emerging economies, outlined above, have implications for empirical research. First, given the dominance of inside ownership and controlling shareholders, the study of ownership structure and its evolution remains an important area of research with respect to emerging economies as the effects of various ownership structures, and their interactions with the institutional environment, tend to differ across countries (Aguilera, Talaulicar, Chung, Jimenez & Goel, 2015). Extant literature suggests that concentrated ownership emerges due to effort by owners to protect their capital in the presence of weak legal and financial institutions (Boubakri, Cosset & Guedhami, 2005; Cuomo, Zattoni & Valentini, 2013; Gomes, 2000; La Porta, Lopez-de-Silanes & Shleifer, 1999). This in turn has effects on the market for corporate control and economic efficiency (Claessens, Djankov, Fan & Lang, 2002). As new institutions develop and existing institutions strengthen, one ought to observe dynamic changes in ownership holdings of corporations in emerging economies, leading to higher activity in the market for corporate control and consequent increases in firm performance.

Second, given the prevalence of business groups and pyramidal structures, and the presence of controlling owners in key management positions, related-party transactions will continue to remain an interesting area of research in the context of emerging market economies. One strand of literature tends to suggest that related-party transactions may lead to economic efficiency due to vertical integration and missing capital markets, particularly within business groups that may provide coinsurance against difficulties or distress faced by member firms (Gordon, Henry & Palia, 2004; Jia, Shi & Wang, 2013; McCahery & Vermeulen, 2005). The contrasting view is that related-party transactions with group companies could be ways of tunnelling resources from companies with low ownership rights to high ownership rights, while related-party transactions with controlling shareholders could be ways of serving the interests of majority inside shareholders at the expense of outside minority shareholders (Aslan & Kumar, 2014; Bertrand, Mehta & Mulainathan, 2002; Boateng & Huang, 2017; Healy & Whalen, 1999; Kang, Lee, Lee & Park, 2014). Empirical research in this area ought to distinguish between the different types and forms of related-party transactions, detect expropriating behaviour, and suggest ways of mitigating them.

Third, with respect to solutions of governance problems, the role played by the board of directors (Abdullah, Ismail & Nachum, 2016), the audit committee (Khan, Muttakin & Siddiqui, 2013) and the outside auditor (Fan & Wong, 2005) remain a focus of empirical investigation for emerging economies. An important issue in this respect is ways of ensuring the “independence” of the outside directors, members of the audit committee and the external auditor, in the presence of controlling insiders who have a decisive say in director and auditor appointments. Consequently, governance arrangements developed for established economies may turn out to be less effective in emerging market environments (Chen, Li & Shapiro, 2011). In this respect, the role and composition of the nomination committee require more attention than has been accorded in the existing literature. Relatedly, board and committee behaviour and engagement in strategic issues deserve more attention compared to structure and composition (Judge & Talaulicar, 2017). Another important issue for achieving good governance in emerging economies is the quality of enforcement (e.g., Dharmapala & Khanna, 2013). A large body of work has documented that while the laws in the book in many emerging economies are comparable to those in many developed economies; the law on the ground is considerably weaker and is plagued by lower quality of implementation, detection and deterrence (Berglöf & Claessens, 2006; Coffee, 2007; Klapper & Love, 2004). In this connection, the role and effectiveness of both public enforcement through legal institutions as well as private enforcement through institutional activism and investor awareness (Berglöf & Claessens, 2006; Chung & Talaulicar, 2010; Jackson & Roe, 2006) constitute important areas of research in emerging economies.

Fourth, the concept of "governance bundles" (e.g., Schiehll, Ahmadjian & Filatotchev, 2014) as solutions to governance problems imply that empirical work on measurement of governance effectiveness must incorporate a combination of governance mechanisms, internal and external, rather than concentrate on any particular mechanism (Bosse, 2009; García-Castro, Aguilera & Ariño, 2013; Millar, 2014). Put differently, the measurement of effectiveness of any particular governance mechanism must take into account the juxtaposition of other complementary and substitute mechanisms without which one risks the problem of incomplete specifications and omitted-variable bias in empirical analysis (cf. Misangyi & Acharya, 2014). A promising development in this area of research is the evolution of the concept of a corporate governance index (e.g., Al-Malkawi, Pillai & Bhatti, 2014; Black, Gledson de Carvalho & Sampaio, 2014; Prommin, Jumreornvong, Jiraporn & Tong, 2016). Notwithstanding the challenges inherent in the creation of an aggregative measure (Black, Love & Rachinsky, 2006), the concept of a corporate governance index may provide an intuitive way of measuring the efficacy of various governance arrangements, where the same governance score can be achieved through a combination of internal and external governance mechanisms.

Fifth, extrapolating the concept of an optimal governance bundle from the viewpoint of the corporation to that of the nation at large, there is the interesting question of whether the path-dependent national governance systems that one observes in different countries across the world are equally efficient in terms of reaching the same governance outcomes, or whether some governance structures are inherently more efficient, with institutional rigidities and path-dependency preventing some national governance systems from reaching an efficient structure (cf. Yoshikawa, Zhu & Wang, 2014). This is the question of formal convergence versus functional convergence (Gilson, 2001) and requires a comparative study of the relative performance of corporations across national boundaries (e.g., Khanna, Kogan & Palepu, 2006), and of the evolution of legal, financial and political institutions.

Finally, the role of corporate social responsibility (CSR) will emerge as an important area of research in corporate governance in the coming years. CSR is still not well understood in developing countries, and deserves more scholarly attention (Wang, Tong, Takeuchi & George, 2016). There is heightened discourse in this area, with most countries making reporting of CSR expenditure mandatory for all listed firms, and with India and China going even further: India by enacting legislation to make CSR expenditure (of two per cent of net profits) mandatory for all listed companies (based on a mechanism of comply-or-explain) and China by requiring state-owned listed companies to undertake CSR expenditure as a part of their contract with the state. Empirical research in this area ought to investigate and comment on whether CSR indeed leads to an increase in social capital, with resultant increases in company valuation and long-run sustainable growth of corporations, or reduces firm value due to diversion of funds from core activities. This research will also benefit from incorporating the institutional environment in which corporate governance and CSR activities are embedded and unfold their effects (Filatotchev & Nakajima, 2014).

Methodological Considerations

Empirical research on corporate governance challenges in emerging economies may also benefit from more rigorous implantation of methodological approaches to ensure better construct validity of data, and to better address causality and potential issues of endogeneity that may be particularly important in the case of emerging economies (Black, Gledson de Carvalho, Khanna, Kim & Yurtoglu, 2014).

There has been increasing attention to identification strategies in corporate governance research, for establishing credible casual inference. Major approaches typically include propensity score matching (PSM), fixed effects, difference-in-differences, event study, instrumental variables, the Heckman selection model, and regression discontinuity. Shipman, Swanquist and Whited (2017) indicate that studies often overstate the capabilities of PSM and fail to disclose important design choices, suggesting widespread misunderstanding about the econometric issues that PSM addresses. For example, PSM addresses endogeneity concerns related to functional form misspecifications but does not address most endogeneity concerns related to self-selection or to omitted variables. Shipman et al. offer suggestions for more convincing implementations of PSM such as using PSM and multivariate regression in combination.

Bowen, Frésard and Taillard (2016) show that identification articles attract 22% more citations than matched nonidentification articles, and point to a secular rise in identification technology in the field of corporate finance and governance. Atanasov and Black (2016) indicate that shocks (i.e., natural experiments or quasi-experiments) provide a stronger basis for causal inference, and shock-based papers on corporate governance have roughly twice as many downloads per paper as non-shock based papers on Social Science Research Network. Regulatory changes on corporate governance rules in emerging countries provide useful shocks that can be used as identification strategies. Atanasov and Black (2016) provide guidance on how to improve shock-based causal inference, even if inference remains imperfect. In using shock-based instrumental variables, for example, the covariate balance between treatment group and control group needs to be shown.

To resume, quantitative studies need to carefully choose suitable research designs based on the nature of any potential endogeneity concerns. Of course, possible endogeneity is only one type of challenge in empirical research, albeit one that has attracted increasing attention. In the area of corporate governance, there are also many questions about which qualitative methods will continue to yield insights (McNulty, Zattoni & Douglas, 2013). More specifically, qualitative research methods may provide much potential to better illuminate the determinants, patterns and consequences of the aforementioned peculiarities of corporate governance in emerging economies.

Research Contributions in the Special Issue

This special issue of the *Corporate Governance: An International Review* is aimed at presenting high quality work on the governance issues and solutions that are characteristic of emerging economies as outlined above. The four articles included in this issue are developed from multiple disciplines engaged in corporate governance research, address different aspects of governance problems in emerging markets, employ diverse theories to guide their studies, and cover various governance environments (in single- as well as multi-country settings).

In the first article entitled "An institutional perspective on corruption in transition economies", Alon and Hageman (in this issue) analyse the level of unofficial payments for tax purposes in 21 transition economies of the former Soviet bloc. They document a negative relation between unofficial payments and rule-based trust measured by rule of law, but a positive relation with dispositional trust, which facilitates the exchange in resources. Since legal institutions are not well developed in Soviet bloc countries, informal institutions (such as trust-based informal networks) play an important role. In these countries, businesses are put in a position where bribes are expected in order to receive services and speed up bureaucratic procedures. The discussion is in line with the findings in Mironov (2015) that corrupt managers in Russia advance shareholder interests through avoiding paying taxes, obtaining government contracts, removing business impediments by paying bribes, and manoeuvring around bad laws.

CEO turnover and CEO compensation are frequently addressed subjects of corporate governance that have been widely studied in the context of emerging economies (Chen, Cumming, Hou & Lee, 2016; Conyon & He, 2014; González, Guzmán, Pombo & Trujillo, 2015; Hoskisson, Johnson, Tihanyi & White, 2005; Pessarossi, P., & Weill, L. 2013; as well as Chizema, Liu, Lu & Gao, 2015; Gallego & Larrain, 2012; Ghosh, 2006; Peng, Sun & Matkóczy, 2015). Prior research has mainly scrutinized the determinants of CEO turnover (e.g., Aivazian, Ge & Qiu, 2005; Cao, Pan, Qian & Tian, 2017; Fan, Lau & Young, 2007; Tsai, Kuo & Hung, 2009) as well as the performance effects and sensitivity of various arrangements of CEO compensation (Conyon & He, 2012; Firth, Fung & Rui, 2006; Mengistae & Xu, 2004). He, Shaw and Fang (in this issue) analyse the relationship between CEO compensation and voluntary CEO turnover. To better illuminate this complex relationship, they consider important institutional moderators, namely labour-market transparency, mobility and competitiveness, and show how these contingencies shape the supply and demand conditions of the managerial labour market. Based on institutional theory, organizational psychology (most notably equity theory) and labour economics, their article indicates how the institutional environment and labour market characteristics tend to link pull-side and push-side drivers of CEO turnover within an emerging economy.

For a sample of 1,409 Chinese listed firms covering the years 2002 to 2011 and including 2,137 different CEOs, the authors demonstrate that underpayment of the CEO tends to increase the likelihood of voluntary turnover. More intriguingly, they also show that this effect tends to be more pronounced when the labour market is more transparent (due to mandatory compensation disclosure rules), labour-market mobility is higher in the region where the firm is headquartered, and the labour market is less competitive (due to higher growth rates within the industry). These findings shed new light on the effects of the managerial labour market on CEO turnover decisions during institutional transition. The findings also inform practitioners regarding the design of CEO compensation design that can motivate able CEOs to remain in office, and that may differ with conditions in the managerial labour market.

Sun, Yuan, Cao and Wang (in this issue) study the impact of reform of the split-share structure in China on the risk of a stock-price crash. The reform terminated the trading constraints on restricted shares of listed firms in China, which were largely held by state shareholders. It aligns the interests between dominant state shareholders and private minority shareholders, which in turn decreases their conflict of interest with private minority shareholders, and reduces the risk of a stock-price crash. The findings add to studies of this arguably most significant leap in the Chinese capital market, which has been found to increase stock informativeness (Hou, Kuo & Lee 2012), turnover-to-performance sensitivity (Chen, Cumming, Hou & Lee, 2016), and both output and profit (Liao, Liu & Wang, 2014).

In the fourth paper entitled “Buying gold at the price of silver? Controlling shareholders and real estate transactions in Korean listed firms”, Yang (in this issue) studies controlling shareholders in Korea. Many firms are controlled by families but not wholly owned by them: the rights to cash flows from the firm are less, often much less, than the rights to control the firm. This structure gives the controlling shareholder an incentive, and the power, to direct their firm to conduct transactions whereby the firm loses and the shareholder or their family interests gain. Since the loss to the firm is shared with the non-controlling shareholders, the family makes a net gain. This tunnelling behaviour is believed to be widely practised. For example, Enriques and Volpin (2007) believe that 'minor forms of expropriation are systemic in continental Europe' (p. 124). However, because tunnelling is a clandestine activity, evidence on its extent and nature can be hard to come by.

Yang's paper exploits data on land prices in Korea that are reviewed annually by the Korean Ministry of Land, whether or not the land has been traded. He identifies a sample of real estate transactions between a listed firm and the controlling shareholder, and calculates the returns, using the officially assessed prices of the relevant property, over three years before the transaction, and over three years after. He documents that, for sales from shareholder to firm, the average return before the sale exceeds the average return after, while for sales from shareholder to firm, the reverse is the case. The inference is that controlling shareholders are able to obtain a favourable price compared with a fair arm's length price, and/or are consistently able to time the transaction, possibly using private information, so that sales (purchases) are made after large (before) price rises. The loss on average to the firm, estimated from a restricted sample where the transaction price is available, is 26% of the firm's operating profit in the relevant year. The paper provides unusually clear and direct evidence of one type of tunnelling behaviour, and the gains that are made from it.

The four articles included in this special issue will hopefully stimulate further research on corporate governance challenges in emerging economies. They offer new insights and provide promising avenues to advance our wisdom on governance peculiarities in developing countries. These peculiarities may encourage new theoretical lenses and approaches as extant theories developed for established economies may inadequately account for the diversity of various markets (Marquis & Raynard, 2015) and insufficiently fit the governance environments faced by firms in emerging economies (cf. Barkema, Chen, George, Luo & Tsui, 2015). These theories may also benefit from a more comprehensive inclusion of the context and particularly the institutional environment in which firms and their governance are embedded (cf. Filatotchev, Jackson & Nakajima, 2013; George, 2015; Meyer & Peng, 2016).

Conclusion

Governance problems and firm-level governance are embedded in country-specific national business systems, and influenced by political, social and legal macro-institutions. Depending on these environmental characteristics, governance solutions and their eligibility can vary widely across countries and particularly between established and emerging economies. The present special issue addresses important challenges of corporate governance in emerging market economies. Due to the peculiarities of these economies, that differ substantially from the much-more-widely-studied established economies, further research remains essential in order to advance our wisdom about corporate governance in developing countries and to inform practitioners and rule-makers about the antecedents and effects of various governance arrangements. We hope that the contributions included in this special issue will inspire and motivate researchers to continue to conduct research in this field so that some of the research perspectives identified in this introduction may soon benefit from new and consolidated insights.

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