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To the Question of Corporate Governance Institutional Environment in Developing and Emerging Markets

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Abstract

This work is an attempt to contribute to thinking about the institutional framework of corporate governance in the context of its evolution in the developing and emerging markets (DEM). We raise the question whether the DEM countries adapt the mechanisms and practices of the corporate governance models of leading economies. We first introduce the concept and genealogy of the new institutional economy. Then we trace the specifics of the modern models of corporate governance and the main factors affecting these models. We finally engage in critical reflection on the problems in corporate governance in both developed and developing markets through the prism of the fundamental, institutional features of each country.

Keywords: new institutional economy, institutionalism, corporate governance, developing and emerging markets

Introduction

In the modern world, intensive research is being conducted on the development of the institutional environment of corporate governance. It is obvious that this environment, which includes various factors – economic, political, cultural, and

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legal – is far from homogeneous. In countries with a developed market economy, the norms, rules, and standards of corporate governance, we can say, have been formed over the centuries, taking into account the peculiarities of the mentality, morals, and lifestyle of a particular region. But even despite such a long period of development, we see how imperfect the system of corporate governance is in those models that are now commonly called American or European. Corporate scandals, fraud and unfair business practices that shake the world occur regularly, despite the fact that the legislation in the field of corporate governance is constantly being improved. Countries with emerging markets that do not have much experience in regulating the corporate sector, with their own unique institutional environment, are trying to adapt existing corporate governance models, mainly American or British. Many scientists wonder about the possibility and necessity of this (Ngwu, Osuji and Stephen, 2017; Kurmanov, 2013; Arslan and Alqatan, 2020; Nazir and Afza, 2018; Rashid, 2018). This work is an attempt to contribute to thinking about the institutional framework of corporate governance in the context of its evolution in the developing and emerging markets (DEM).

Literature Review

Institutional Framework of Corporate Governance

Institutionalism, or Institutional Economics, which is considered the founder of the American scientist T. Veblen, is one of the schools of economic theory that studies the influence of social institutions on the economic behavior of people. Published in 1899, T. Veblen's work «The Theory of the Leisure Class: An Economic Study of Institutions», laid the foundation of the so-called «traditional» institutionalism (Veblen, 1899). Later, in the XX century, the concept of «modern» institutionalism appears, which is divided into Neo-institutionalism and the New institutional economy. According to Seligman, one of the most famous American economists, the birth and development of institutionalism is a kind of «revolt against formalism», since in addition to strict theories and rigidly verified models and methods, this theory takes into account a variety of life realities (Seligman, 1968).

American historian of economic thought Robert L. Heilbroner noted that «economic science has finally transcended the narrow confines of its former realm – the realm of production and distribution – and can now claim a vast territory stretching from family relations to sports, from anthropology to state law» (Vinogradova, 2012).

In the XX century, modern institutionalism made a revolutionary breakthrough in economic science, where, according to the Nobel laureate D. North, «institutions matter» (North, 1990). Institutional Economics has become the domain of «knowledge about the rules of economic behavior: how they «work», how they are formed and changed, and the costs and benefits associated with their creation, change, compliance, and violation» (Auzan, 2005). The main prerequisite for the emergence of this direction of economic science was the transition of Ricardian capitalism to the monopolistic stage. David Ricardo, a stockbroker married to a banker's daughter, introduced the term Capitalist, and breathed life into him and created a class for the creature to live with. Ricardian Capitalism means that the Capitalist owns the means of production and collects the residual while others get paid enough to regenerate the energy expended (Stiglitz and Sassen, 2002). Monopolistic capitalism, which is highly centralized capital and production, caused a sharp increase in the stratification of society into rich and poor and generated acute social contradictions. But the «old» institutionalists believed that only a high concentration of production would make it possible to offset the shortcomings of the spontaneous mechanism of market competition by bringing a greater strategic focus and innovation to the companies' activities.

The further development of monopoly capitalism led to the fact that, first in the United States and then in Europe, the entrepreneurial model of doing business began to change to a corporate one, which led to the formation of a new institutional environment. Published in 1932, and now become a classic book "Modern corporation and private property" by A. Berle and G. Means reveals the nature of the corporate form of ownership, when ownership is separated from management, ownership itself is blurred among a huge number of co-owners

(shareholders), and management is conducted by executive managers (Ricardo, 1821). The essence of relationships between shareholders and managers was discovered by Jensen and Meckling (1976) as a principal-agent problem and led to many institutional changes in trying to align managers behavior with shareholder interests (Berle and Means, 1932). In 1992 a committee chaired by Sir A. Cadbury in response to the series of corporate failures in the UK produced a report entitled *The Financial Aspects of Corporate Governance.* According to this code UK listed companies being required to comply with the code, otherwise explain the reasons for non-compliance (Jensen and Meckling, 1976). Since then, there have been many studies in the field of corporate governance, explaining what is “good” or what is “poor” corporate governance (Cadbury, 1992), what is “reasonable” or “rational” in corporate activities (Blok, 2020), published thousands of works, but as many scholars admit, “we still know very little about corporate governance” (Nordberg, 2018).

The Models of Corporate Governance

The term "Corporation", derived from the Latin word corpus, which means" body", is a set of persons who unite to achieve common goals, carry out joint activities and form an independent subject of law - a legal entity (Ahrens, Filatotchev and Thomsen, 2011).

The organization for economic cooperation and development (OECD) defines corporate governance as the system by which companies are managed and controlled (Wikipedia). This applies to how rights and responsibilities are distributed among the Board of Directors, Executive managers, shareholders, and other stakeholders, as well as how decisions are made regarding the company's operations.

Today, there are several models of corporate governance. One of the major experts in this field, B. Tracker, believes that there are five of them:

1. The US rules-based model
2. The UK/Commonwealth principles-based models

3. The continental European two-tier model
4. The Japanese business network model
5. The Asian family-based model

Many factors in the economic, legal, social, and cultural environments in which these models were created influenced the formation and development of these models (OECD Council, 1998). The most important ones include patterns of ownership, financing of corporate entities, markets for corporate control, and customs and traditions. Particularly, ownership in listed companies around the world varies, from the highly dispersed to the singularly concentrated. For example, in the US, 92 percent, and in the UK, 77 percent of all shares are owned by individuals or institutional investors, meaning that title is dispersed among multiple shareholders. In Japan or Germany, on the contrary, there is a high concentration of assets in the hands of banks and holding companies (more than 51 percent of all shares). Accordingly, in those countries where ownership rights have a high level of dispersion, the stock market is usually well developed, and as a result, the company's activities are financed through it. And in countries where the stock market is relatively small, companies are financed through non-equity loan capital. Consequently, the role of banks and holding companies becomes significant, and power and influence is concentrated in their hands. As for the markets for corporate control factor, it is very strong in countries such as the US or the UK. As a result, merger and acquisition activity is likely to be widespread as well as a hostile takeover bid. On the contrary, in Germany the first contested hostile takeover bid was registered in the 1990s (Almaskati, Bird and Lu, 2020).

Methodology: assessing strengths of the corporate governance models

Now let us take a closer look at each of the above corporate governance models. Many experts often tend to combine the US and UK corporate governance models into a single, so-called Anglo-American model. We agree that the environment in which these company management practices were formed and the models

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themselves have a lot in common. This includes a unitary board, with a predomination of independent outside directors; mandatory audit, remuneration, and nomination committees of the board; little influence of shareholders on board membership, etc. However, the models have many fundamental differences between them. The most important difference is that the American corporate governance model is rule-based. This means that government regulatory agencies, including the Security Exchange Commission, have developed rules and regulations that must be strictly followed.

In contrast, the British model is principle-based, or it is also called the «comply or explain» model. Its essence is that there are no strict rules, you need to follow the recommendations or the corporate governance code, and if you cannot follow them, you need to explain the reason. So, the UK model is more based on a self-regulation approach, where the main purpose is to ensure that investors or potential investors have accurate information on which to base their judgments.

The continental European two-tier model is also ruled-based, but it is dominated by the fact that the title is concentrated in the hands of banks and holding companies, as in Germany or the Netherlands, or family clans and the state, as in France or Italy. The continental European model is also characterized by a two-tier Board of Directors, which consists of the upper, supervisory board, and the lower, management board or committee. The supervisory board is comprised entirely of outside directors and the management board entirely of executive directors. The continental European model also has a significant social component. For example, 50 percent of the supervisory board should be made up of representatives of employees of the company who will protect their interests.

The Japanese business network model has many similarities with the continental European two-tier model in terms of a large concentration of assets in holdings and banks, but in the Japanese model, in most cases this occurs through crossholdings and interlocking directorship. This creates a network of companies which is called in Japan Keiretsu. Another feature of the Japanese model is the large number of people on the Board of Directors. While a 15-member Board of Directors

is considered too large for American or British companies, a 30-or even 50-member Board of Directors in Japan is common and considered normal. And only 13.5 percent of them are outside directors, the rest are insiders.

The next is the Asian family-based model, which shares similarities with the previous model in terms of company management styles and methods, such as centralized decision making and paternalistic management style. But the peculiarity of this model is that most shares are owned by certain families, and, consequently, companies are controlled by families. This model of corporate governance is typical for South Korea, Hong Kong, Singapore, Malaysia, and some other countries in Southeast Asia.

Thus, each of the presented models has its own characteristics and fits the conditions of the country in which it originated. Therefore, the Japanese model, for example, is not suitable for the United States or Canada, and the European model is not suitable for Southeast Asian countries (Tricker, 2015).

Findings and Discussions

Corporate Governance in the Developing and Emerging Markets

Developing and emerging market countries include countries such as the former socialist camp, Turkey, Latin America, India, and many others. As you can see from this list, these are completely different countries, each with its own history, economic and political background, as well as social and cultural characteristics. Nevertheless, many of them have been adopting the American or British corporate governance models. The main reason of this is because of the socio-economic and political influence of the United States and the United Kingdom even despite the fact that, over the past twenty years, the world has been shaken by corporate scandals, fraud, and bankruptcy among American companies.

Due to the fact that, as previously mentioned, the title of ownership is dispersed among many shareholders, equity markets are relatively large, with high liquidity

and significant turnover, boards of directors and executive managers can wield significant power over their companies. Even though ultimate power lies with the voting shareholders, de-facto they act not as owners of the company. They act simply as investors what means they are interested only in their returns on invested capital (El-Hodiri and Zhussupova, 2020; Kultys, 2016; Chan and Cheung, 2012; Zhussupova and Nurmagambetova, 2016). Real company's owners, first of all, take care about future perspectives, company's strategies and long-term market capitalization. To act as real principals, shareholders do not have full access to company's financial records as executive managers do. This deep asymmetry in access to information allows executive officers act in their own interests. Thorstein Veblen in his "Theory of Business enterprise", alerted us to the fact that the business enterprise has one and only one purpose: to make money (Lojpur and Draskovich, 2013). Never mind the American myth that the firm makes money by adding value and that the owner collects the money. One look to the end of the year account of any American corporation is enough to convince us that production is not the main source of income to the corporation nor do the profits go to the shareholders. It goes to the CEO, in the form of bonuses and hence the shocking rise in share prices.

Despite these systemic shortcomings of the American corporate governance model, many developing countries are trying to adopt it at home and work based on US principles. However, as we see in practice, despite many years of work in this direction, the corporate governance system in developing countries is far from the original, as corporations in China, India, Latin American countries, CIS countries, including Kazakhstan, work in their own realities. In many of these countries, the stock market is underdeveloped, the profitability of companies is dictated by political forces, and the rights of minority shareholders are not respected. In addition, there are failures in the legal regulation of corporate governance, lack of qualified personnel, excessive bureaucratic system, and much more. The neoliberal orientation of the Anglo-American model does not consider the fundamental, institutional features of each developing country. It is possible that the Anglo-

American model of corporate governance does not fit the formal and informal institutional conditions of these countries.

Corporate Governance Institutional Reforms in Kazakhstan

In Kazakhstan, as in other republics of the USSR, almost all property belonged to the state, which owned, disposed of, and carried out operational management of it, including all income and profits of enterprises. The state independently redistributed goods between economic entities in accordance with the principles of social justice. The state centrally developed strategic and tactical plans for enterprises considering economies of scale. With the transition to a market economy, new forms of ownership and new ownership relationships have emerged, including for natural resources. By the way, the transition to a market economy was carried out, in our opinion, by barbaric methods, the key component of which was privatization. Thus, privatization became one of the main elements of institutional changes in the former Soviet republics, which laid the foundation for the corporate governance system. According to J. Stiglitz, privatization was accompanied by a massive stripping of assets of enterprises, which, for example, was avoided in Poland. Poland was more focused on corporatization (Stiglitz and Sassen, 2002). In addition, for various reasons, the relevant institutional environment was not created in a timely manner, which allowed manipulating rental income in favor of the investor. Subsequently, a system of inefficient institutions took the place of an institutional vacuum (Vinogradova, 2012). Only in recent years, in our opinion, there have been some positive changes in the field of corporate governance in Kazakhstan, such as:

- conducting systematic audits;
- the presence of at least one third of independent Directors on the Boards of Directors;
- development of corporate codes and introduction of standards of corporate behavior;

- implementation of information disclosure rules and regulations.

When carrying out further corporate governance reforms in our country, we need to consider the fact that despite the massive privatization of the 90s, the state still owns the production giants of our economy. In our opinion, they should go through the process of denationalization using the IPO system, and turn to public companies, and citizens of the country should become real co-owners of property that is initially public.

It has long been known that state-owned holding entities such as Samruk-Kazyna, Baiterek, and others operate inefficiently. Over the course of its existence, state-owned holdings have turned into large structures with bloated staff, which mainly include individuals affiliated with high-ranking officials in one way or another, and thus consume huge budget resources. Many subsidiaries spin off from them, creating a so-called quasi-public sector, which also receives its benefits. Thus, the form of state property management through the creation of state holdings that have a controlling stake or full control over the assets of state-owned companies has demonstrated its insolvency.

The Government should try to involve most of the country's population in the process of denationalization (possibly through attracting pension savings). Otherwise, the corporate governance practice that currently exists in Russia may develop. The specifics of privatization mechanisms in the Russian Federation determined the so-called insider nature of corporate governance mechanisms, which involves the concentration of share capital in the hands of a limited number of people, a high level of competition between shareholders, top managers and external stakeholders in order to maintain control over the company, the lack of development of the institute of independent directors and market control over the corporation, etc. (Veblen, 2017).

One more our suggestion is to expand the powers of the Supervisory Board of joint-stock companies, whose members should only be independent directors. If their affiliation with the company is established, the joint-stock company should be

subject to strict penalties. Despite the rapid development of this Institute, its effectiveness, however, leaves much to be desired. This is primarily due to the lack of a clear definition of an independent director in the legislation, as well as the fact that quite often an independent director in a company performs decorative functions. Besides independent directors, we think each Board should contain representatives of the companies' employees like Worker directors in German corporations. Then the corporate form will really have a democratic character, along with the fact that a wide range of people, including employees of the company, become shareholders, and holding shares makes it possible to participate in generating additional income and managing the company through participation in the General meeting of shareholders (Moskovtsev, 2008).

Conclusion

In this paper, we have tried to analyze the essence of corporate governance in modern institutional conditions, critically comprehend the advantages and disadvantages of each model of corporate governance, realize the fact that each country has its own historically established institutions, and blind copying of someone else's model will not lead to the desired results.

J. Wolfensohn, the former president of the World Bank said that proper management of companies will be as critical to the global economy as proper management of countries. Today's realities show the validity of these words. To ensure the sustainability of economic growth during the third industrial revolution, and later in the era of Industry 4.0, it is necessary to build an effective system of corporate governance in an institutional environment that would provide reliable guarantees of property rights, transparency and availability of information, information disclosure, and respect for the rights of shareholders.

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