DISSERTATION

Can Economic Openness Inspire Better Corporate Governance?

An Exploration of the Link between Openness and Corporate Governance based on the Asian Experience

Lisa C. Klautzer

This document was submitted as a dissertation in March 2013 in partial fulfillment of the requirements of the doctoral degree in public policy analysis at the Pardee RAND Graduate School. The faculty committee that supervised and approved the dissertation consisted of Krishna B. Kumar (Chair), Edward G. Keating, and Michael D. Greenberg.

RAND PARDEE RAND GRADUATE SCHOOL

The Pardee RAND Graduate School dissertation series reproduces dissertations that have been approved by the student's dissertation committee.

Published 2013 by the RAND Corporation
1776 Main Street, P.O. Box 2138, Santa Monica, CA 90407-2138
1200 South Hayes Street, Arlington, VA 22202-5050
4570 Fifth Avenue, Suite 600, Pittsburgh, PA 15213-2665
RAND URL: http://www.rand.org
To order RAND documents or to obtain additional information, contact
Distribution Services: Telephone: (310) 451-7002;
Fax: (310) 451-6915; Email: order@rand.org

Summary

Introduction

Good governance is a key factor for stable economic development and many international aid initiatives and developing countries' domestic policies focus on improving public sector governance. Corporate governance, however, has not received as much attention particularly in the context of developing countries. This lack of attention seems negligent given that sustained economic growth ultimately depends on a thriving private sector and examples of corporate governance failure have been shown to be highly disruptive, even in developed economies. The premise of this dissertation is that policymakers, in their quest to maximize economic growth, have to consider corporate governance and find ways to enhance it so as to stimulate private sector competitiveness and reduce unexpected failures.

One way of doing so is to enhance legal requirements of corporate governance standards (in particular, shareholder protection) and enforce adherence. However, in developing countries, two things, in particular, may impede a government's ability to do this. For one, public institutions may be weak and have limited resources and may therefore not be able to enforce such requirements well. Secondly, private companies have often grown out of family businesses, frequently resulting in highly entrenched business interests. This small, but powerful, group stands to lose possibilities to extract profits from their firms (and minority shareholders) under stricter corporate governance standards. Therefore, a more market-driven approach to improving corporate governance may be a good alternative or complement to regulatory efforts.

Developing countries are, furthermore, often characterized by weak domestic markets, limiting companies' access to local capital, suppliers and customers. In this respect, economic openness (defined for my purposes as the degree to which economies allow [or enable] trade or actually trade with other economies) can provide a mechanism to overcome such shortfalls of the "home market." Competing with foreign companies for global investors, customers, and suppliers may, in turn, change the cost-benefit analysis of domestic companies with respect to their corporate governance standards. For example, the controlling stakeholder may gain more through access to cheaper (foreign) capital than he or she loses through the limitation of his or her expropriation possibilities. This is because foreign investors have, at least initially, less knowledge and experience

with the domestic market and place higher value on good corporate governance practices, as these provide a risk mitigation mechanism.

In this context, I am interested in exploring the link between economic openness and companies' corporate governance practices in developing countries. In doing so, I will clarify what I mean by "corporate governance" and "economic openness" and how to measure these concepts. Furthermore, I will consider which factors affect the cost-benefit analysis of a company when deciding on corporate governance practices and how economic openness can impact this so as to create a conceptual framework. I then empirically test the hypothesis that economic openness can stimulate the adoption of better corporate governance practices using data from eleven Asian countries. I focus on Asian countries, as over the last decades, their accelerated economic growth has led the way in catching up with developed countries and at the same time the region displays overall a variation in both economic openness and corporate governance practices.

The focus on the impact of economic openness on corporate governance in developing countries is particularly novel as much of the existing literature has thus far only looked at the general question of determinants of corporate governance. Furthermore, this research complements existing evidence by looking at specific aspects of corporate governance, including ownership structure, financial information, and information about the board. Methodologically, the research goes beyond observing correlations to looking at whether there is evidence for a causal link between economic openness and corporate governance.

Methods and data

The design of the conceptual framework, definition of the individual elements (i.e., corporate governance and economic openness) and the choice of the measurements used to operationalize these elements is informed by a review of peer-reviewed and gray literature. The latter is comprised of informally published material produced by a variety of stakeholders including government, academia, and the private sector, which is not captured in the typical sources of peer-reviewed literature. The core data ultimately chosen to proxy corporate governance are firm-level scores on transparency and disclosure with respect to corporate governance issues collected in 1999/2000 by Standard & Poor's. For the empirical exploration, a basic ordinary least squares (OLS) regression model is used in conjunction with an instrumental variable approach to test whether there is a causal effect of trade openness on corporate governance.

Key findings

Our results point to three key findings:

Finding 1: Economic openness has a positive effect on corporate governance practices

Overall, the key findings of the OLS analysis provide support for my hypothesis that a country's economic openness is positively and significantly related to better corporate governance practices of the publicly listed firms incorporated in that country. On average, companies in economically more open countries adopt more transparent reporting on corporate governance issues in their annual reports. According to the baseline regression results in which I control for annual sales (as a proxy for firm size), sector, and gross domestic product (GDP) per capita (as a proxy for a country's development level), a ten percentage point increase in trade shares is estimated to increase overall corporate governance scores by 0.8 percentage points. For example, based on these parameter estimates, if India, the least open country in the sample (at the time trade made up only about 21% of GDP) moved to the level of Thailand (where, at the time, trade made up about 87% of GDP), its overall corporate governance scores would increase by 13 percent. When instrumenting economic openness to avoid biased results due to endogeneity between corporate governance and economic openness, the OLS results hold. This suggests that a country's economic openness level is not only correlated but even causal for better corporate governance practices. In fact, the estimates imply that the effect of a one percentage point increase in trade shares (i.e., imports and exports expressed as shares of GDP) would have about the same positive effect on good corporate governance practices as a 107 U.S. dollar (USD) increase in GDP per capita. This level of magnitude would be especially important for less developed countries. For example, if I were to apply these estimates to low and middle income countries as a whole I would get the following: With an average GDP per capita of 1,017 USD in the 1990s and trade shares of about 44 percent, a two percent growth rate in trade shares would have generated the same improvement in their firms' corporate governance practices as a ten percent increase in GDP per capita.

Finding 2: Ownership reporting is more sensitive to economic openness than other reporting areas

Companies in economically open countries tend to report, in particular, more on issues related to the company's shareholder composition and investor rights. Albeit still positive and statistically significant, reporting on financial issues (i.e., business strategy and auditing practices) is less sensitive to the degree of economic openness. This may suggest that foreign partners are especially interested in (or concerned about) the ownership structure of companies in Asian countries. Such a focus makes sense in light of the prevalence of family-controlled businesses and the extensive use of complex control structures (e.g., pyramid ownership structures, cross shareholdings) in Asian countries, which typically raise corporate governance concerns for outside investors.

Finding 3: Taiwan is a marked outlier

Taiwan is a marked outlier in terms of the intuitively positive link between economic development and good corporate governance. Orthodoxy would suggest that Taiwan's relatively high economic development would imply its firms adopting good corporate governance practices. However, Taiwanese firms display poor corporate governance. This notable abnormality can, however, be explained based on Yeh et al. (2001)'s findings. They argue that Taiwan is characterized by an extremely high extent of family-controlled businesses, but that performance does not suffer if levels of family-ownership are high enough, given that the costs of expropriation outweigh the benefits for the family. Thus, family-controlled Taiwanese firms may be economically successful while not feeling the need to provide transparent information to outsiders (e.g., minority shareholders).

Policy implications

These findings have several policy implications relevant for domestic and foreign policies aiming to enhance corporate governance, which in the long run could help foster economic development in developing countries.

First, the fact that openness has a positive effect on corporate governance suggests that direct or indirect exposure to foreign markets changes a firm's cost-benefit analysis in favor of improved corporate governance practices. Companies can learn from their interaction with foreign partners or are inspired to improve their practices to increase attractiveness to potential foreign partners. This means that a certain "knowledge transfer," which happens with production technologies, can also happen with respect to corporate governance mechanisms. Thus, in some sense, we can "export" good corporate governance. Little is known about the interaction between corporate and public sector governance, but there are plausible channels through which an improvement in corporate governance practices could have spillover effects to the public sector. Not only would sound and transparent corporate practices reduce the possibility of opaque payments to corrupt government officials in exchange for certain concessions (e.g., procurement contracts, regulatory favors) as suggested by Wu (2005), good governance culture could also be transmitted through human capital transfers between the private and the public sectors.

In this light, developed countries may be more successful in promoting a well-functioning private sector in developing countries by establishing policies aimed at their own participants in the international market that are actively trading with and investing in developing countries than by pushing for corporate governance-related regulations through an inefficient public sector in the developing countries themselves. Companies in developed countries could become agents of change through standards imposed on them that they can, in turn, translate into standards required for their suppliers, trading partners, or companies they invest in. One could think about it in similar terms as the Foreign Corrupt Practices Act (FCPA); when it comes to fighting corruption in foreign countries, the FCPA imposes significant consequences (e.g., penalties of up to USD 25 million and the suspension or debarment from securing contracts with the U.S. government) to U.S. companies that commit bribery abroad, thus reducing the supply of money to be used in developing countries to corrupt public sector authorities. It should, however, be noted that such approaches may have tradeoffs as they may impede on the competitiveness of U.S. firms.

Conversely, policymakers in developing countries can, based on the bi-directional relationship between economic openness and corporate governance practices, promote a "virtuous cycle" by stimulating either economic openness or the adoption of better corporate governance practices at the firm level. In particular, policymakers should consider that promoting policies directed at both factors can, in conjunction, ease the adoption of these policies. For example, policymakers may need to expend less political capital to negotiate stronger corporate governance rules with controlling shareholders if better corporate governance also means enhanced business opportunities abroad. Furthermore, a more market-driven approach that would focus on enhancing openness instead of regulating the private sector directly may save public resources that would otherwise be required for enforcement efforts.

Concluding remarks

This dissertation aims to a) provide an overview on what corporate governance means to different stakeholders and how we can measure it, b) establish a framework guiding research into the intricate relationships between economic openness, governance, and economic development, and c) empirically explore the specific link between economic openness and corporate governance.

In sum, my findings suggest that trade openness can have a positive impact on the adoption of good corporate governance practices. The potential positive long-term impact of economic openness on public (Bonaglia et al., 2001) and (as I find) corporate governance points to the fact that cross-border interaction can strengthen institutions. In practice, the positive effect of economic openness can help devise and promote policies that leverage market forces and a) might more easily gain support from entrenched business communities as they go hand-in-hand with new business opportunities abroad, and b) be more efficient as they do not depend on public sector monitoring.