CHAPTER 3

Governance of Firms

Corporations exist to economize the costs of buying and selling everything under the sun.

—Ronald Coase, 1937

In firms, entrepreneurs match their ideas and ability with the resources provided by investors. Throughout history entrepreneurs have found that their ability to pursue investment projects has been hindered by the inevitable time gap between when they gather resources and when they can make payment. Investors—be they workers, suppliers, or financiers—are cautious about committing their resources to the control of an entrepreneur in exchange for a promise or contract.

For the investor, there are two distinct risks. One is the squandering of resources by the entrepreneur; the other is the confiscation of goods by a political power. This chapter focuses on the governance of firms, which is largely a matter of the allocation and exercise of control over resources within firms. A variety of private and public institutions make promises and contracts credible by improving information inflows, defining rights and enforcing them, and affecting competition. These institutions are essential for the mobilization and efficient allocation of resources through firms.

Corporate governance institutions are defined in this Report as the organizations and rules that affect expectations about the exercise of control of resources in firms. Well-functioning governance institutions allow entrepreneurs to invest resources and create value that is shared among the investors in a firm, the managers, and employees, as well as with the entrepreneur/manager. These institutions therefore determine the expected returns to committing resources in firms. Where governance institutions are weak, the emergence and growth of firms are discouraged. Governance institutions include traditional corporate governance mechanisms, such as the board of directors and corporate and bankruptcy laws (chapter 6); product market institutions such as regulators responsible for competition (chapter 7); labor market institutions (discussed in *World Development Report 1995: Workers in an Integrating World*); capital market institutions, such as financial intermediaries (chapter 4); and the judiciary (chapter 6).

Historically, two broad institutional approaches have been used to assure investors that their resources will be put to good use in firms: a *private* and sometimes *informal* approach, and a *legal governance approach.* Both approaches facilitate information flows and create incentives for investors to focus on firm efficiency and to monitor insiders. They aim to give resource providers the power to intervene without incurring heavy transaction costs when entrepreneurs and managers abuse their control.

For an example of the private and informal governance approach, consider the situation in the 12th century, when many governments were weak in much of the world. At the time one of the most promising investment opportunities involved expanding from trade *within* local communities to long-distance trade *across* communities. In the traditional approach entrepreneurs reduced trading risks by relying on self-finance and on family or community members. Private institutions relied on reputational penalties to enforce contracts (chapters 1 and 9). This approach facilitated market development by permitting entrepreneurs to move from a situation of very limited exchange to a situation of some (and occasionally considerable) trade.

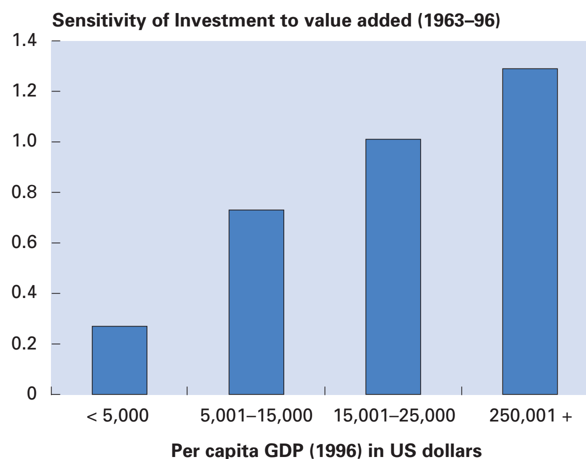
The legal governance approach developed the typical firms that emerged from the Industrial Revolution. These firms in later history differed from their predecessors in scale and scope. The standard relationship among firms was hierarchical to ensure coordinated production and marketing. In the 19th and 20th centuries, more formal governance institutions, such as explicit contracts and laws to protect investors, allowed firms to exploit opportunities created by the Industrial Revolution. The development of constitutional and legal systems designed to check arbitrary behavior of public and private agents strengthened property rights. These institutions spurred market development, economic growth, and poverty reduction.

The advantage of the legal governance approach is that it can expand wealth-creating opportunities, making it possible to assemble the significant resources needed for large enterprises and facilitating entry into markets. Identification with a network is not required to pursue opportunities. New entrants do not need to have social connections or large amounts of initial wealth to start a business. This approach relies far more heavily on a state that imposes legal sanctions and enforces contracts. By enabling productivity-enhancing investments, these legal institutions can promote growth and poverty reduction.

A recent study that examined the efficiency of resource allocation by firms shows that not all firms have effective governance. For 65 nonsocialist countries between 1963 and 1996, and for large and small firms with both state and private ownership, the study estimated the average sensitivity of industry investment to industry value added in the manufacturing sector.[1] A high degree of sensitivity would reveal two forces at work. Firms and industries where investment projects yield strong returns as measured by value added would be able to attract added resources, and these industries would expand. By contrast, where past investment projects are now yielding declining returns, as measured by value added, investment would decline and industries would contract.

The findings indicate that in lower-income countries the degree of sensitivity is low, so that investment is much less likely to be affected by changes in value-added (figure 3.1). In Germany, Japan, and the United States the sensitivity of investment to value added is twice as great as in Mexico, three times that of Malaysia, and more than six times that of Bangladesh, India, and Kenya. This compounds the problem for poorer countries because such investments are critical for higher growth and poverty reduction. Resources are slow to flow to industries that experience increases in their ability to create value and remain for long periods of time in industries where there has been a reduction in the value created. They "underinvest" in growing industries and "overinvest" in declining industries.

Figure 3.1
Flows of new investment are insensitive to value added in developing countries



Source: Wurgler 2000.

Corporate governance institutions, including institutions that provide legal protection for investors, institutions that produce information for investors, and ownership structure of firms, are highly correlated with these measures of the efficiency of investment. After accounting for other factors, the same study finds that an increase in any of these variables increases the sensitivity of resource allocation to changes in value added. For example, better legal protections for investors are highly associated with a greater willingness to curtail new investment flows to industries that experience declines in value added. For a country like Bangladesh, this sensitivity would double for an increase of one standard deviation in any of the institutional variables. This suggests the importance of better firm governance for growth and poverty reduction.

A range of other factors plays a role in creating these differences in the efficiency of investment. The ability of firms to exploit opportunities in some growing industries is limited by differences in macroeconomic conditions, demand conditions, entry restrictions (see

chapter 7), and the supply of critical inputs into productive industries. Without denying the importance of such factors, the focus here is on the role of governance institutions for firms.

Formal governance institutions offer long-term benefits. Such institutions increase opportunity for firms by promoting investment in high value added activities. By promoting the growth of firms and employment within firms, these institutions can increase economic growth and reduce poverty. Yet the development of laws, internal governance institutions, well-developed financial and information intermediaries, and effective regulators often faces large obstacles. The effectiveness of these governance institutions depends on the existence of complementary institutions and on capacity. Thus, in poor countries, where there are few limits on arbitrary state actions, weak enforcement of contracts, and poor provision of information, private institutions rather than legal governance institutions are likely to dominate.

Policies that help build political support for legal reforms and create demand for new institutions, such as openness in trade and open information sharing among the different parties affected by reforms, are as important as the specifics of individual reforms. Competition can also increase the efficiency of such private mechanisms and promote institution building. And developing country policymakers will need to be open to innovative approaches by private agents to ensure effective governance.

The chapter begins by looking at the types of firms that exist around the world. It then discusses the presence and effectiveness of private governance institutions, which include ownership concentration, business groups, and business associations, and goes on to identify corporate governance institutions based on formal legal systems, such as boards of directors and corporate and bankruptcy laws. The chapter does not discuss governance of state-owned firms, which was addressed in *World Development Report 1997: The State in a Changing World* and other recent World Bank publications. Issues concerning infrastructure firms are discussed in chapter 8.

What firms around the world look like

The vast majority of enterprises are small in most countries, regardless of their geography or level of development. The importance of small formal sector firms in selected countries is highlighted in table 3.1. Even in the transition countries, known for their large firms, most firms are small. If informal sector firms were included, the numbers would be even larger.

In small firms, particularly sole proprietorships that rely on internally supplied resources, governance issues are much simpler than in large firms. A study of 54 industrial and developing countries finds that in developing countries, the growth of small and medium-size enterprises is constrained by institutional factors.[2] For smaller firms which have the potential to grow, the willingness and ability to mobilize resources within firms is affected by the presence of an arbitrary or predatory

Table 3.1
Share of small formal sector firms in selected economies, selected years

		Percentage		
Economy	Year	Number of firms	Employment	Total output
Australia*	1991	92.0	35.7	23.1
Austria	1990	75.5	20.2	14.6
Belgium	1991	97.2	38.4	50.3
Bulgaria	1997	97.5	18.9	21.8
China*	1991	58.9	6.0	5.2
Colombia*	1993	93.4	40.5	27.4
Croatia	1995	96.9	26.7	34.9
Denmark	1991	98.3	55.4	46.5
France	1990	98.6	46.7	39.0
Georgia	1997	82.0	26.0	42.0
Hong Kong, China	1993	97.8	58.4	53.8
Hungary	1996	98.8	53.1	46.5
India*	1992	76.2	17.3	13.4
Indonesia*	1995	98.7	73.2	28.4
Israel*	1992	93.9	39.4	—
Italy	1989	99.2	63.4	53.9
Japan	1991	98.1	66.5	—
Jordan	1991	93.7	21.5	—
Kazakhstan	1996	87.6	23.9	25.9
Korea, Rep.	1995	98.5	55.3	25.2
Latvia	1996	98.3	41.1	39.8
Lithuania	1996	98.0	43.1	41.8
Netherlands	1990	96.7	49.7	46.5
Norway	1990	81.5	54.8	50.5
Portugal	1991	99.0	48.7	43.7
Romania	1997	97.4	19.5	40.1
Spain	1991	99.4	67.5	—
Sweden	1991	97.6	39.5	41.4
Switzerland	1991	97.5	39.5	—
Turkey*	1992	86.7	28.3	25.7
United Kingdom	1991	98.5	42.1	19.5

*Refers to firms in manufacturing industries only.

— Not available.

Note: Small firms are defined as registered firms with fewer than 50 employees.

Source: World Bank Small and Medium Enterprise Database.

state (for example, firms may start small and remain small to avoid taxation or harassment by the state). The institutions that can help provide checks on the authority of the state are discussed in chapter 5.

Resource mobilization is also affected by the absence of a strong legal system that supports markets, such as a court that ensures that debts are repaid (chapter 6). For smaller firms, private governance institutions play a more important role than formal corporate governance mechanisms in allocating control rights or claims *within* the firm. Other institutions that may facilitate entry and growth of firms relate to competition and regulation, discussed in chapters 6 and 7.

Despite the preponderance of small firms, large enterprises can account for significant fractions of employment and national output (see table 3.1). While the small firm sector includes a large number of firms with widespread entry and exit, large and established firms are more stable across economies. For instance, one study finds that growth in the size of firms accounts for over two-thirds of all industry growth.[3] Much of this chapter is concerned with large firms and those smaller firms that have the potential to grow. It is in these firms that concerns about diversion of resources by insiders and the state are most important.

The vast majority of enterprises are also not publicly traded. Publicly listed firms constitute 0.16 percent of all registered firms in developing countries and 0.55 percent in industrial countries, according to a sample of 37 countries around the world.[4] However, publicly traded firms are still important, as they may account for a significant share of the economy. For example, publicly listed firms account for around 40 percent of value added in the United Kingdom, and for 25 percent of value added in Japan. In developing countries such as Poland and Thailand, publicly traded firms account for 7 and 9 percent of value added, respectively. Although the number of these large firms and of publicly listed firms is small compared with the number of firms, the economic importance of these firms in the economy can be substantial. Because of their size, their performance can also have significant political and social consequences.

Many of the differences in the size of firms depend on the nature of demand and supply of goods and services, as well as differences in government policies such as taxation. Some of these differences, however, arise from differences in the effectiveness of private and formal governance institutions for firms.

Private governance institutions for firms

There are three main kinds of governance institutions that are not formal laws: ownership structures, business groups, and associations. These three institutions affect the amount of information available to all parties involved with a firm, contract enforcement, and accountability of entrepreneurs and managers to those who invest in the firms.

The amount of information available to all parties involved with a firm influences how investment projects are financed. In the absence of full information about the firms and those who control them, investors demand higher returns. Information problems mean it is relatively cheaper for firms to use internally generated capital first, then trade credit, then debt finance (where limited control is given up in exchange for finance), and, last, equity finance (where control rights over the firm are exchanged for finance). Two types of investors usually have an informational advantage compared with others. Investors who by the nature of their transactions with the firm have a better idea of the prospects of the firm, such as suppliers to and buyers from firms, can ensure that entrepreneurs or managers adhere to their commitments. Large investors also have advantages because their large stake in the company gives them voice so that they do not need to rely on elaborate legal protections.

In smaller firms, with concentrated (or sole) ownership, the principal governance issues concern the implicit or explicit contracts that the owners have with traders and suppliers, with employees with firm-specific skills, and with banks and other financial institutions. Suppliers and buyers extend credit to their business partners. The provision of trade credit embodies implicit contracts; purchasers expect the debtor firm to produce the goods at a certain price, quality, and quantity.[5] Evidence from a sample of 40 industrial and developing countries indicates that there is less reliance on trade credit and more reliance on other forms of credit when the country's legal system is well developed. This suggests that the comparative advantage of nonfinancial firms in providing credit is likely to be smaller when well-developed alternatives exist.[6]

As the size of firms increases, day-to-day control and overall management are delegated to nonowners. The division between owners and managers makes governance issues more complicated. Looking across time in individual countries, there is a correlation between the strength of institutions that support information flows

and provide legal leverage to the nature of financiers, and ownership structures. The United States today has one of the strongest and most effective legal protections for equity investors. In the 19th century, before these institutions had developed, the financing and ownership of firms differed dramatically from current patterns. Before 1873, for example, the only investors that owned simple equity were founders and sponsoring banks. Bank representatives on corporate boards provided a low-cost monitoring system for the large equity investors. Individual investors, aware of these concerns, limited their involvement to holding corporate debt or preferred stock that had debt-like features.[7]

How ownership concentration affects governance

In lower-income countries, firm ownership tends to be highly concentrated. Large firms controlled by management and owned by a diverse group of small shareholders are the exception rather than the rule.[8] There is a relationship between ownership structure and the strength of legal institutions across countries, with concentrated ownership tending to substitute for weak legal protections.[9] Concentrated ownership gives investors information and control and so ensures that their resources are used in their interests. Concentrated owners have the ability to halt the diversion of resources without having to resort to courts. In high-income countries, with stronger legal protections, ownership is more dispersed. But this is not uniformly the case. Countries such as Germany and Sweden, which have strong legal protections, nonetheless have concentrated ownership structures, but there firms have more choice with respect to governance and dispute resolution mechanisms (chapter 6).

The primary advantage of more concentrated ownership is that it motivates the shareholders to monitor the managers of the firm *and* provides the owners with leverage over the managers. But with concentrated ownership, governance problems may arise between different categories of investors—such as minority and majority shareholders. Majority shareholders may act in ways that reduce the share of gains going to minority shareholders; they may pursue private benefits.

Evidence suggests that concentrated ownership delivers greater benefits when those owners in control have appropriate incentives and when owners outside the firm have more leverage. A study of firms in East Asian economies, for example, found that the market placed a higher value on those firms whose controlling shareholder had a larger equity stake.[10] With larger equity stakes, the controlling shareholders' wealth is more directly linked to the performance of the firm. Cross-country work also provides evidence that investors are willing to pay more for assets when, besides a controlling shareholder, there are legal protections that grant shareholders, regardless of their size, rights over the allocation of resources and returns.[11] Legal protections complement concentrated ownership and enhance firms' access to external finance. They enhance the firms' ability to fund more promising investment projects. The potential negative effects of concentrated ownership can also be reduced by introducing competition in markets (chapter 7) and by ensuring the exit of underperforming firms (see the discussion below).

Ownership structures in privatization: lessons for corporate governance. The spread of privatization programs around the world has been propelled by the inefficiency of state-owned firms and the resulting search for significant improvements in performance. But there have been disappointments, particularly in the transition economies. Squandering and diversion of resources by political actors have often been replaced by squandering and diversion of resources by private actors. This has raised a new question about privatization: how to ensure that it produces benefits. It has become clear that competition and regulation are essential complements to successful privatization (chapters 7 and 8). This section focuses on how differences in corporate governance institutions also help to explain differences in privatization outcomes.

Ownership structures chosen at the time of privatization by political actors reflect economic and political concerns. The two predominant approaches to privatization are to use public share offerings, which are more likely to result in wide share ownership, or asset sales, which are usually associated with the sale of a majority stake to a single investor or to a consortium. Voucher privatization, used in some transition economies, like public share offerings, introduces more widely held firms than direct asset sales.

In most countries, the choice of privatization method has been linked to the strength of formal corporate governance protections. Both the strength of legal protections for minority investors and the extent of checks and balances on political actors—which enhances enforcement of legal protections—have a significant impact on the privatization route, according to a recent study of 49 industrial and developing countries.[12] Countries with

weaker legal protections have been more likely to use asset sales. But even though the initial level of legal protections was low, several of the transition economies used voucher privatizations as their primary form of sale.

In countries where initial institutional quality was high, privatization has been associated with significant improvements in institutional quality. A study finds that privatization has had a significant impact on stock market development around the world.[13] The market capitalization of privatized enterprises now exceeds $2.5 trillion. Such enterprises are the largest companies in 17 of the 23 emerging markets in the study. These firms are of sufficiently high profile and political importance that they can lead the way in improving corporate governance structures. Evidence of actual or potential abuses of authority in such firms has been a driving force behind legal reforms.

The counterbalance to these positive developments is the indication that in countries with weak institutional quality at the initial stage, formal governance institutions have not developed and those that have developed have been difficult to sustain. For example, a World Bank study of stock market development in transition economies shows that privatization policies that relied on the development of formal corporate governance institutions for effectiveness, by compelling firms to list on stock exchanges as part of the privatization process, have not succeeded in developing markets.[14] In mass privatization countries—such as Bulgaria, Lithuania, and the Former Yugoslav Republic of Macedonia—many of the stocks were illiquid, and stock market regulators, to the extent they were available, could not monitor adherence to listing standards. These problems have resulted in significant delisting of shares, reports of abuses of minority shareholders, and a subsequent concentration of control. Following an initial increase in the number of listed firms, there has been a steady decline.

More promising, from the perspective of long-term trends in stock market development, have been initial public offerings (IPOs) in countries such as Croatia, Hungary, Poland, and Slovenia, which sold a smaller number of stocks. Some hybrid countries used both methods. A recent study finds that in transition economies the strongest performance improvements are associated with firms that have concentrated ownership structures, particularly when the concentrated owner is foreign.[15] The study estimates that the impact on performance is eight times greater for foreign ownership than for widely held firms.

Recent experience in Latin America illustrates the difficulty of relying on privatized firms to spur institutional development. Initial sales of shares in companies brought with them significant portfolio investments, diversified ownership structures, and increased stock market development. But the governance institutions have not been sufficiently strong to maintain these ownership structures, particularly in light of abuses by controlling shareholders. In recent years ownership structures have changed, with foreign companies assembling controlling majority stakes.

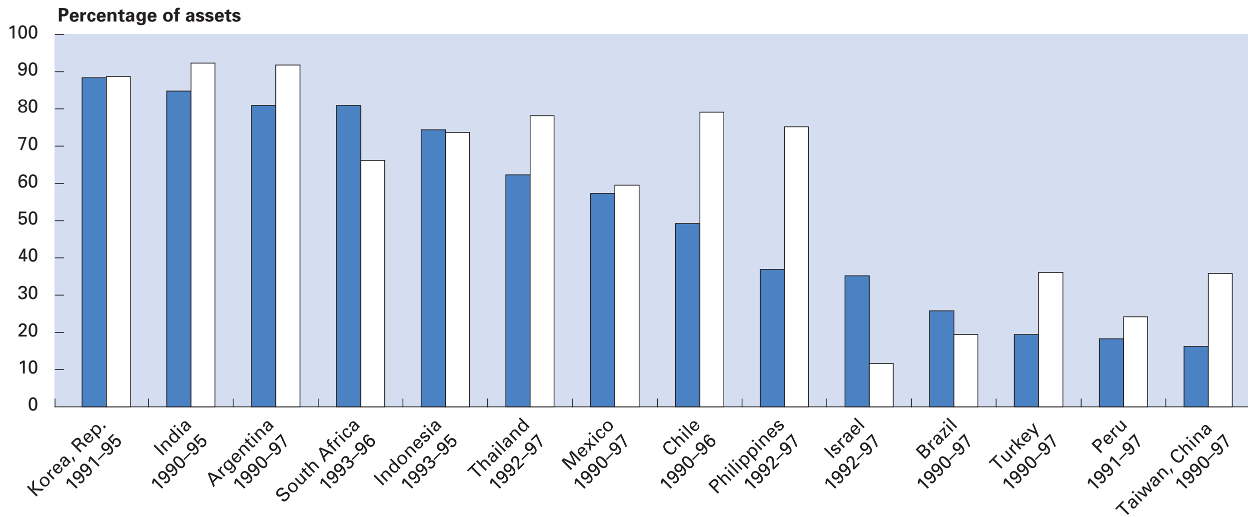
Business groups

Many business opportunities are exploited through firms affiliated with business groups, which are a group of companies that do business in different markets under a common administrative or central control.[16] Members of business groups may be small, medium-size, or large firms, although large firms usually dominate the groups. Equity holdings across companies and common directors provide a coordinating mechanism within groups, but ties among group members are also made through family and social relations.

Business groups exist across the world. The *keiretsu* in Japan, c*haebol* in the Republic of Korea, *grupos economicos* in Latin America, and business groups in China and India are examples of ways to organize and conduct business along different lines, outside and around the formal market mechanisms. A study of 14 developing countries provides some systematic evidence of the importance of group-affiliated firms.[17] The findings for publicly listed firms on which financial information is available is displayed in figure 3.2. The study finds that group-affiliated firms dominate the business landscape, controlling on average more than 52 percent of reported assets in 1990 and 59 percent in 1997 in these countries.

Business groups are central to the process of resource allocation within firms in developing countries. Despite advances in financial and trade liberalization, the dominance of group-based resource allocation has not diminished over time. World Bank research provides evidence of how economic power is concentrated in relatively few hands through business groups. In Japan the top 15 families control less than 3 percent of the GDP value of listed corporate assets. The contrast with lower-income countries in East Asia such as Indonesia, the Philippines, and Thailand is striking. Here the top 15 families account for more than 50 percent of listed cor-

Figure 3.2
Proportion of assets in publicly traded firms accounted for by group-affiliated firms



Source: Khanna and Rivkin 2001.
Note: This exhibit is derived from the data used and described in Khanna and Rivkin 2000. The authors used all available data in each reference year, but financial information was not available for some listed companies.

porate assets and more than 20 percent of GDP in each country.[18]

The creation of business groups can be viewed as a private response to institutional weaknesses in markets. For example, without strong financial and information intermediaries, capital markets work poorly at pricing risk and providing a source of capital for investment. Group-affiliated firms, in principle, can create an internal capital market, financing new firms and cushioning members during financial downturns. In the absence of functioning markets for corporate control, group affiliation can also coordinate the replacement of underperforming management teams. In countries where active executive labor markets do not exist, internal labor markets within groups can match management talent with assets.

On the negative side, where groups dominate business, there may be little competition among those who control resources, since information and control rest with a few centrally located actors. If these people are not skilled or well motivated, resource allocation will suffer and they might extract funds for personal gain from the firms they control. Group-affiliated firms are often affiliated with banks and may be able to attract a major share of enterprise financing to the exclusion of outside enterprises. The interests of groups may also conflict with the interests of social welfare. The economic power of groups translates into political power, and that power can be used to extract preferential treatment from political agents or to block reforms.

There is evidence to support both views of business groups. If it is true that group affiliation is a response to weaknesses in markets, it should be possible for group firms to expand their scope of activity quite broadly through diversification. Evidence from Chilean and Indian firms suggests that diversified business groups can deliver superior performance compared with nonaffiliated businesses when the groups are large enough. For example, firms associated with the most diversified Indian business groups outperformed focused unaffiliated firms by 22 percent but outperformed firms in moderately diversified business groups by 43 percent.[19] Groups also appear to play an important role in exploiting new business opportunities in some settings. This is consistent with earlier evidence from Japan, which showed the ability of group-affiliated firms to operate internal capital markets. The Toyota automobile company started off as an offshoot of a business group that was focused on creating machinery for the textile industry. Recent studies of 14 countries with significant business groups examined whether such groups systematically filled in for gaps in capital markets

Box 3.1
Business groups and restrictions on competition in Kazakhstan

Over the latter part of the 1990s, many large and medium-size enterprises in Kazakhstan came under the control of five national-level business groups and multiple regional groups with political connections. The concentration of economic power in these business groups has created the incentives and the ability to lobby government agencies and public officials for preferential treatment, in such areas as trade restrictions, non-market-based financing, preferential public contracts, and protection from new entrants. Bank financing is often directed to these firms, but repayment is not enforced. As a result, state governments often pay indirectly for these loans.

Business interests with political clout have also used their power to harass competing firms. One illustrative case is described in a recent report commissioned by the U.S. Agency for International Development. A local entrepreneur had established a profitable small hotel. But a new hotel, whose owner had political influence, opened close to the existing one. Soon after, the local sanitary inspector closed the first hotel, claiming that the supply of running water on the premises was inadequate. The experience, however, ended on a positive note. After two years of court battles and the intervention of the regional governor, the first hotel was reopened.

Source: Djankov and Nenova forthcoming.

and delivered superior performance. There was significantly better financial performance in group-affiliated firms in six of the countries, significantly worse in three, and no significant effect in five countries.

There is also evidence that group affiliation can be associated with negative outcomes, particularly when groups are controlled by entrepreneurs with weak incentives or ability. In Russia and Kazakhstan a few groups have been able to dominate many industries and foreclose financing and business opportunities for other entrepreneurs (box 3.1). In East Asian economies the market has placed a lower value on firms where the controlling shareholder had control through group structure but lower equity stakes.[20] Lower market value in such group-affiliated firms implies higher cost of access to external finance from non–group members. But the continued existence of such structures implies that the benefits of group membership to firm owners must outweigh these costs.

The key policy question is how to increase the benefits that business groups bring while lowering the costs. Policies to open firms to domestic and international competition are one obvious answer. Access to export markets provides a greater incentive for group-affiliated firms to focus on efficiency—which highlights the importance of institutions that improve product market competition (chapter 7).

Experience also suggests that capital market openness can reduce the potential costs imposed by business groups while allowing firms to capture benefits from membership. In India, for example, firms with foreign institutional investors performed better than those with domestic institutional investors. In Canada the capital and labor market liberalization following the passage of the North American Free Trade Agreement between the United States and Canada has attenuated some of the costs associated with firms run by family members and has also begun to reduce the dominance of these structures.[21]

Formal business associations and informal networks

Business associations—voluntary, long-term, renewable partnerships among firms—are another set of private institutions that can facilitate exchange and the expansion of business activity. They do this by improving information flows, enhancing reputational penalties, and lowering the costs of dispute resolution. Relative to alternative private approaches, such as business groups or ethnic-based trading associations (chapters 1 and 9), these organizations are more inclusive and adaptable to changes in the surrounding environment.

Business associations are widespread in many industrial and developing countries. In some cases governments have mandated membership.[22] In Brazil during the 1930s, for example, the government created compulsory associations for both labor and businesses. By the mid-1970s, the business sector had also created many voluntary associations, sometimes parallel to the government-created ones. By the mid-1980s most large and medium-size businesses in Brazil belonged to several associations.[23]

The characteristics of business associations vary greatly across countries. In some cases business associations are industry-focused, while in other cases as in the transition economies, they cut across industries. In some cases membership in associations may be mandatory. In general, however, the observed high levels of membership arise largely from voluntary integration of firms into business associations.

A handful of studies have attempted to explore whether business associations perform socially benefi-

cial functions.[24] Cross-country comparisons indicate that business associations perform a variety of functions. These can be grouped into market-supporting and market-complementing and -substituting functions.[25]

- *Market-supporting functions*: Business associations operate as a counterpart in dialogue with the government. They channel and coordinate an individual firm's efforts in lobbying for the improved provision of public goods, such as protection of property rights, better public administration, and infrastructure.
- *Market-complementing and -substituting functions*: Business associations operate in parallel with existing institutions by providing alternative private solutions for market failures. For example, they lower the costs of acquiring information on potential trading partners and provide a means to coordinate and amplify penalties for breach of contract (box 3.2).[26]

Cross-country comparisons suggest that the role of business associations may change as markets develop. For example, in Russia basic trading information is a critical input for enterprises, and business associations have specialized in providing and diffusing information. In the more stable institutional environment of Bolivia, business associations have other functions. These include business counseling for new enterprises and, for older enterprises, matching prospective employees with employers. Bolivian associations facilitate the establishment of small start-ups: the average number of days necessary to open a new business is 41 for members, but almost 65 days for nonmembers. At the same time, associations reduce labor search costs for medium-size enterprises: the average number of days required to fill a vacancy is 36 for a member, compared with 51 for a nonmember.

Business associations are more effective when they provide well-defined benefits to members, have high membership density, and have an effective internal interest-mediation system.[27] These conditions, however, are not sufficient to guarantee effectiveness. Two external constraints—a competitive environment and appropriate discipline by the state in refraining from discriminatory behavior and corruption—promote effective associations.

When formal legal systems that support information flows and accountability are underdeveloped, a careful evaluation of corporate responses such as ownership concentration and business groups is needed. Concentrated ownership and business groups can substitute for formal institutions in providing the functions of governance. But competition in markets and the threat of bankruptcy are necessary complements, to provide checks and balances for those who control resource allocation within firms. Steps to eliminate these structures without addressing weaknesses in formal institutions are unlikely to succeed. Even if they were to succeed, it is not clear what the benefits would be in the absence of an alternative functioning governance framework. From this perspective, the goal of those aiming to improve corporate governance should be to address the underlying market failure, to facilitate conditions where networks are beneficial and to develop alternatives, to introduce competition into the economy, and to enhance openness in trade and information flows.

Box 3.2
Business associations and trade credit

Extending trade credit to a potential buyer involves risk. Membership in organizations that facilitate the sharing of information on potential buyers can help reduce this risk and promote a firm's growth.

A study of five transition economies—Poland, Romania, Russia, Slovakia, and Ukraine—using firm-level data suggests that membership translates into better trade credit terms, especially for business relationships older than two months. A study on Kenya and Zimbabwe shows a similar effect, with potential buyers identified through business networks more likely to receive trade credit than other customers. Firm-level data on Vietnam provides added evidence on the role of business networks as information-sharing mechanisms, with the relationships established through these networks facilitating better access to trade credit. Firm-level data suggest that business associations and arbitration courts are substitute mechanisms for resolving disputes between trading firms.

Source: Johnson and others 2000; Fafchamps 1999; McMillan and Woodruff 1999a; Hendley, Murrell, and Ryterman (2000).

Laws and formal intermediaries

With formal corporate governance institutions, there can be specialization in delivering the functions of governance. Some institutions, such as disclosure laws, auditing firms, and financial and information intermediaries, focus on bridging information gaps. Other institutions, such as corporate and bankruptcy laws and their associated enforcement institutions, specialize in lowering the costs of dispute resolution. Yet other institutions, such

as boards of directors, specialize in managing remaining incentive problems stemming from information gaps between entrepreneurs and managers.

For these formal governance institutions to operate effectively, several related conditions must be met. The information available to resource providers must be timely, accurate, and reliable, and in a form that regulators and investors alike can understand. The laws that limit the authority of entrepreneurs or managers must be enforced efficiently by competent and impartial judges (chapter 6). The demands on the state increase with greater reliance on formal institutions. Not only do state actors directly determine the costs of dispute resolution, but state actors are closely involved in bridging information gaps by setting specific standards and by affecting the incentives of private information intermediaries.

The most basic measure of legal protections is the degree to which courts can be expected to enforce contracts and refrain from confiscating assets (chapter 6). A recent study finds that expectations of basic contract enforcement affect firm size, after accounting for a variety of other contributing factors such as the state of demand, technology, and type of industry.[28] Although the study is restricted to the European countries, differences in legal protections probably help explain the significant differences in firm size between industrial and developing countries as well.

The absence of complementary formal institutions may make legal reforms difficult. One study found that statutory legal protections in Russia, which were much lower than the world average in 1992, were some of the world's highest by 1998.[29] But coincident with these improvements in measures of legal protections has been reportedly weak enforcement, which has driven down equity values. Anticipated benefits from the adoption of sophisticated legal protections is limited because developing countries have low levels of enforcement of basic legal protections. The priority is facilitating enforcement, through efforts to create an effective and constrained state (chapter 5) and to improve the efficiency of the judiciary (chapter 6), or to adopt legislation that does not strain the capacity of legislators and politicians.

A question is whether countries need to adopt sophisticated corporate and bankruptcy laws at all. Arguments in favor of mandated protections for outsiders—that is, financiers—are that there are advantages to having checks that protect unsophisticated investors and to the standardization offered by national laws which lower enforcement costs. Arguments against such protections are that they can limit potential innovations by investors and entrepreneurs. In principle, some argue, all that is required is for the state to uphold contract law and for companies to devise efficient protections and write them into their articles of association

History, however, reveals the political necessity for more sophisticated laws, written and enforced by governments. All countries that have had corporate forms for a significant period have, through innovation and experimentation, produced specific laws that shift power away from entrepreneurs, such as corporate and bankruptcy laws. In other words, they have developed sophisticated legal protections beyond contract law (box 3.3).

The empirical question remains whether more detailed laws that allocate power to providers of resources—and influence the organization of firms—improve the way resources within firms are allocated. Recent efforts to quantify the extent of legal protections for equity and debt financiers provide some answers (box 3.4). This evidence suggests that there is a strong association between the presence of legal protections and indicators of current and future firm performance. It also suggests that increased legal protections create the possibility for more diversified ownership structures—moving away from concentrated structures dominated by the state, business groups, and foreign firms—because they allow the protection of minority shareholders. Figure 3.3 shows the relationship between shareholder rights and stock market development. In countries with weak protection of shareholders, dominant or controlling shareholders can expropriate benefits that would otherwise accrue to minority shareholders.

Parties controlling corporations may find such control valuable, since they are able to extract private benefits from the corporation, to the exclusion of other stakeholders. They can influence who is elected to the board of directors or the appointment of the chief executive officer, and they can transfer assets on nonmarket terms to related parties or consume resources at the expense of the firm.[30] A competitive market for corporate control can discipline firms that provide poor returns for investors. But in most countries, takeovers are rare. In practice, the effectiveness of the market for control as a corporate governance mechanism depends on having liquid stock markets, and the costs of mounting a takeover are high.[31] Moreover, incumbent controlling

Box 3.3
The need for formal laws: the development of corporate law

The United Kingdom, France, the United States, and Germany were the first countries to enact corporate statutes. They have spearheaded the development of corporate law. The United Kingdom had features of free incorporation as early as 1688; France proclaimed free incorporation in 1791; the state government of New York passed a corporate statute in 1811; and the German government passed a commercial code in 1861.

Laws of incorporation signaled a shift of authority over resources within firms from the state to private parties. They preceded sophisticated corporate laws, which allocated authority among the different private parties involved in firms. Economic crises following the passage of free incorporation laws, with booms in firm formation followed by busts, motivated the governments of all four countries to establish specific points of leverage and control for investors. For example, Germany's first national corporate law was replaced by a much more restrictive one in 1884, following a crisis. Innovation and experimentation led policymakers to identify decisions that could compromise the resources provided by investors—such as a change in the firm charter, the dissolution of the firm, or the volume or pricing of shares in the firm—and shifted power over these decisions away from insiders. Protections for labor were introduced primarily in bankruptcy rather than corporate laws, with employees given priority over unsecured claims and sometimes over secured claims.

Across industrial countries, governments introduced these protections, which suggests the political if not economic inability to sustain a system that relied solely on sophisticated investors and insiders devising their own mechanisms to deal with potential disputes.

Source: Pistor and others 2000, *World Development Report 2002* background paper.

parties and management have been vocal in lobbying governments to provide antitakeover protection.

A recent study measuring the private benefits of control in 18 countries with the largest stock markets (as of 1997) finds that these benefits are significantly different across countries and may amount to much of firm value.[32] The value of these benefits ranges from a quarter to a half of market capitalization in Chile, Korea, and Mexico. In contrast, private benefits are on average below 4 percent in Denmark, Hong Kong (China), Sweden, and the United States. Legal protections can play a large role in limiting expropriation of company value by those in control. The study shows that the weak legal rights that noncontrolling shareholders enjoy explain more than 70 percent of the systematic differences in private benefits, especially for the quality of general investor protection, minority rights in the transfer of control, and standards of law enforcement.

Box 3.4
Measuring the strength of legal protections for shareholders

Quantitative measures of legal protections focus on the degree to which national laws shift power from management or controlling shareholders.[33]

Shareholders exercise their power by voting for directors and by voting on major corporate issues. Evaluation of the extent of shareholder protection focuses on voting procedures within firms. Investors are better protected when companies in a country are subject to one share–one vote rules. When votes are tied to dividends, insiders cannot have substantial control of the company without having substantial ownership of its cash flows, which moderates incentives to divert resources from the firm. Laws in different countries allow divergence from the one share–one vote principle. Companies can issue nonvoting shares, low and high voting shares, founders' shares with extremely high voting rights, or shares whose votes increase when they are held longer. Companies can also restrict the total number of votes that a given shareholder can exercise at a shareholders' meeting, regardless of how many shares the shareholder controls.

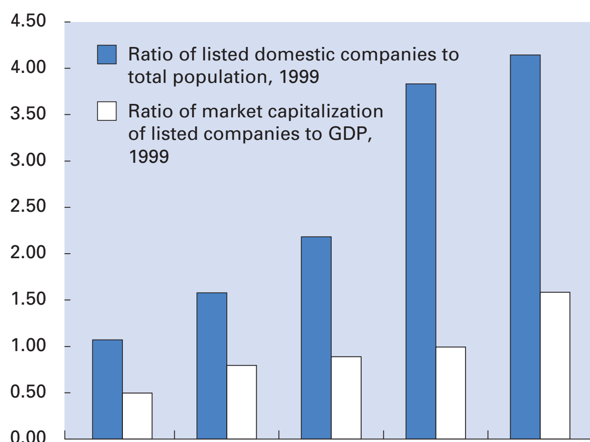
Corporate law specifies rules protecting the voting mechanism against interference by insiders. A recent study constructs a measure showing how strongly legal systems protect minority shareholders against managers or dominant shareholders in the corporate decisionmaking process. Six basic rights are identified.

First, must shareholders show up in person to vote, or may they send an authorized representative or mail their proxy vote? Second, are shareholders prevented from selling their shares several days before a shareholder meeting? Third, is cumulative voting for directors allowed? This gives more power to minority shareholders to put their representatives on boards of directors. Fourth, do minority shareholders have legal mechanisms to guard against perceived oppression by directors, besides outright fraud, such as the right to force the company to repurchase shares of minority shareholders who object to certain basic decisions of the management? Fifth, do shareholders have a preemptive right to buy new issues of stock, to protect shareholders from dilution? Sixth, what is the percentage of share capital needed to call an extraordinary shareholders' meeting? In Mexico, for example, it is 33 percent, which prevents minority shareholders from organizing a meeting to challenge or oust management.

Source: La Porta and others 1998.

Despite the benefits from introducing formal institutions of corporate governance, shifting from a network-based system imposes costs on established

Figure 3.3
Shareholder rights and stock market development



Source: La Porta and others 1998.

members of a network. Established firms are able to accumulate surplus capital because of their reputation for repayment, their ability to provide collateral, or their ability to enforce repayment by others. The implied redistribution of benefits helps to explain the widespread resistance to many governance reforms by leading business groups around the world. Similarly, managers who have free rein are likely to oppose reforms that shift power to outside investors.

One potential force for change is openness to trade and financial flows, which changes the relative power of interest groups and their returns. Incumbents might favor openness because it increases export opportunities or the availability of low-cost capital for them. But openness is often reciprocal, and the result is the introduction of competing firms and foreign investors that have different corporate governance institutions. Foreign competitors in product markets might have lower costs of capital, leading to domestic pressure for legal reform and to lower costs associated with legal protections. Foreign investors need access to information through public channels to identify opportunities and because they are not part of established networks, and they need legal protection in case of abuse. Foreign firms and investors therefore enter to constitute new interest groups.

In some countries—for example in Latin America—the trend among domestic firms toward foreign stock market listings has also been a catalyst for change. The evidence points to rapid changes in regulations in response to financial flows in some areas, but slower movements on disclosure legislation and on corporate, bankruptcy, securities, and labor laws. Brazil is a case where there has been more rapid change on regulations affecting the securities market than in securities and corporate laws (box 3.5).

Resolution of insolvency

Bankruptcy law is an important governance institution that allocates decisionmaking power and claims to assets during times of financial distress. Efficient insolvency regimes, in terms of bankruptcy laws and enforcement mechanisms, make both debtors and creditors better off. Insolvency regimes balance the objective of protecting the rights of creditors—essential to the mobilization of capital for investment—and preventing the premature liquidation of viable enterprises. The evolution of most systems also shows the importance of balancing social and political pressures. The evolutionary paths of corporate insolvency procedures

Box 3.5
Legal and regulatory change in Brazil

The Brazilian stock market is the largest in Latin America and has traditionally been dominated by a few large companies. Firms are often controlled by families or by state-owned corporations, and boards of directors tend to be dominated by insiders. Multiple classes of shareholding facilitate the extraction of benefits by insiders. By one estimate, the private benefits that a controlling shareholder can extract from the value of the company is among the highest in the world—some 23 percent of firm market value in 1997. These features have limited market development and stimulated many proposals for reforms.

Meanwhile, parallel reforms have been undertaken by the securities market regulator to improve disclosure requirements and protect minority shareholders during changes in corporate control. A series of directives from the regulator requires disclosure of the terms and prices of block sales of shares and now requires a mandatory offer for minority shares when the threshold of 50 percent of votes is reached. These regulations have triggered a noticeable reduction in the private benefits that a controlling shareholder can extract from a company.

Source: Nenova 2001b.

have depended to a large extent on who initiates legal changes and on prevailing economic and social pressures (chapter 1). This section discusses some important elements of bankruptcy law.

The details of the law matter. Both the letter of the law and the structure of the insolvency system matter for economic outcomes. This is demonstrated, for example, by comparing the 1992 and 1998 Russian bankruptcy laws. The law of 1992 stipulated that the condition for initiation of bankruptcy was that the total amount of outstanding debts exceed the total value of company assets on the balance sheet. But this condition was not effective because it was relatively easy for a manager to manipulate the balance sheet value of the company's assets.[34] With low transparency and few legal safeguards, it was difficult to ascertain the true condition of firms or to act against poor performers. In contrast, the 1998 law was modified to make initiation of bankruptcy easy. A creditor holding even a small amount (less than $5,000) of debt overdue for three months could file for the bankruptcy of the firm. As a consequence, the number of initiated proceedings jumped from 4,320 in 1997 to 8,337 in 1998, and to over 13,000 in 1999.

The adoption or modification of bankruptcy laws has often occurred in periods of economic crisis, such as the recent East Asian financial crisis. During these times, when maintaining stability in output is a concern, bankruptcy laws have tended to become more debtor-friendly. This has been the case in Indonesia and Thailand, as well as in Argentina. Historical examples confirm the importance of financial crises in the design of bankruptcy systems. The United States, for example, initially had a very creditor-friendly law, which was subsequently revised to be more debtor-friendly during crises (chapter 1).

As a result of the East Asian financial crisis, all the affected countries passed new bankruptcy legislation. The key question is whether such legal changes merely redistributed pending claims or whether the value of claims—for both debtors and creditors—increased. A recent study shows that values for all parties—creditors and debtors—increased in reaction to anticipated reforms in the Thai bankruptcy system.[35] Following positive news about reforms, there was a large increase in the value of claims. Equity values of both corporate borrowers and creditor institutions increased more than 25 percent.

For small entrepreneurs, personal bankruptcy law is important. Most new firms begin as sole proprietorships. For these firms, personal bankruptcy rules have a significant effect on the risks they bear in setting up a business and on the decision to set up a business itself. For example, a study in the United States finds that potential entrepreneurs in states with unlimited homestead exemption in case of bankruptcy have 25 percent less chance of securing a loan. This is because creditors have less collateral to claim in case of default. But homeowners in these states are 40 percent more likely to start a business.[36]

Principles of insolvency regimes. Legal rights for creditors expand firms' access to credit, as well as the breadth and depth of debt markets. A simple way to protect creditors in insolvency is to respect the absolute priority of claims in bankruptcy or restructuring by paying senior creditors first, followed by junior creditors, and finally shareholders out of the residual value. But if shareholders receive nothing during bankruptcy, managers acting on behalf of shareholders will attempt to delay or avoid bankruptcy, for example, by undertaking high-risk projects when the corporation runs into financial distress. For this reason, the preservation of some part of firm value for shareholders during bankruptcy, even when absolute priority would not leave residual value for the owner, is usually recommended.[37]

An important consideration is whether the law provides for an automatic trigger that makes a firm file for bankruptcy—for example, nonpayment or delayed payment on debt, as was stipulated for Russia. Automatic triggers reduce the loss of value associated with managers or major shareholders delaying the bankruptcy decision. They also help to clarify the rights of different parties when complementary institutions are lacking (see the example from Hungary in chapter 1).

The presence of complementary institutions can be critical, so the trigger must be carefully designed. The Thai bankruptcy law of 1999 introduced a trigger stipulating that if the debtor owed a group of creditors more than one million baht, the main creditor had to petition for bankruptcy.[38] However, the trigger did not have the intended effect because complementary institutions were absent. Although the trigger itself was well defined, the next step in the bankruptcy procedure—the determination of insolvency—was not. In particular, nine conditions of insolvency were set forth in the Bankruptcy Act 2483. These were difficult to meet, re-

sulting in few bankruptcy cases being initiated even after the revised law came into force. The accounting rules also did not specify in what currency the company's assets should be recorded, which made it easier for owners to manipulate the balance sheet and make the company appear solvent, preventing creditors from filing for bankruptcy.

Social and political considerations can dominate the ranking of creditor interests. Country experience indicates that social considerations are paramount in times of financial distress. Corporate bankruptcy law usually affects large firms whose financial difficulties may have significant regional or employment effects. Some countries have introduced creative variations on the normal liquidation procedure in an attempt to alleviate the negative impact on employees. For example, a procedure similar to a process under English insolvency law was recently introduced in Kazakhstan. The enterprise is sold as a unit to a new owner, and a contract is signed requiring the new owner to rehire all employees. Creditors, who often provide the acquisition financing, generally support this procedure. In 2000 nearly 38 percent of liquidations in Kazakhstan were conducted under this procedure. Variations of this procedure exist in many countries, such as Indonesia and Korea. A downside of this procedure is that potential new owners may be unwilling to rehire all the employees, and it may not be economically viable for the firm to keep all its workers.

Another important consideration in the design of bankruptcy laws is deciding who can file for reorganization or liquidation. Related concerns are the attention paid to the debtors' and the creditors' roles, the roles of the company's management and other stakeholders in preparing reorganization proposals, the ability of management to operate the company during the reorganization, and whether an automatic stay of assets exists. For example, studies show that the ability of managers to keep their positions adversely affects creditor rights and is associated with less access to external finance.[39]

The evidence from industrial and developing countries indicates that the success of structured or formal bargaining mechanisms in bankruptcy depends on the strength of the judicial system. The efficiency of the insolvency procedures in producing quick resolutions determines who files for formal bankruptcy. Several developing countries have established specialized judicial or quasi-judicial bodies to deal with insolvent companies, taking the proceedings out of the court system.

But not all these experiments have succeeded in improving outcomes. In India, for example, the Board for Industrial and Financial Reconstruction was established in 1987 to reorganize or liquidate insolvent large and medium-size companies. However, in its 13 years of existence the board took, on average, 1,664 days from the time of registration to decide on reorganization plans, and 1,468 days to decide on liquidation.[40] In addition, 35 percent of cases registered in 1996 were still undecided at the end of 2000, along with 63 percent of cases registered in 1997.

Alternative procedures for dealing with financial distress center on versions of asset sales or cash auctions. Cash auctions are easy to administer and do not rely on the judicial system.[41] Although attractive from a theoretical perspective, these proposals have not been widely used, other than in Sweden and Mexico. A problem with the auction mechanism is its reliance on liquid secondary markets. Simplified institutional designs—such as automatic triggers—that clearly state which actions should be taken and leave less room for discretion are more effective in developing countries with weak administrative capacity and limited information flows (chapter 1).

Boards of directors as a check on insider authority

The board of directors of a firm is in a position to play a pivotal role in defining its strategic direction. Moreover, the board's responsibility for executive recruitment and for setting compensation policy and rights over dismissal gives it leverage over managers.

The roles and duties of board members depend on national laws as well as on company statutes. The importance given to various stakeholders' property rights varies across countries. In the United States the board's duty is to shareholders, while in the Netherlands the objective is to achieve a satisfactory balance of influence of all stakeholders. In many countries, such as Germany, directors have a duty beyond that to shareholders and the law also mandates that larger firms include representatives of labor on the board.

The extent to which boards protect the interests of investors and other stakeholders and hold managers accountable depends on the incentives and powers of the board. Board members serve as a weak check on insider authority when insiders appoint and dismiss board members themselves. Voting rules, such as the absence of cumulative voting, ensure that whoever has the most shares can appoint all the board members. In

such circumstances, board members will be more inclined to represent the interests of those who appointed them rather than the interests of a broader set of investors in the firm. Moreover, compensation for services has historically been only weakly related to firm performance, giving the board a poor incentive to focus on monitoring insiders.

In recent years a broad consensus has developed on the elements required to increase the incentives of board members to monitor managers and provide a check on abuses of authority. Private sector organizations in over 30 countries have issued codes of "best practice." Building on analysis of boards and performance in industrial countries, recommendations focus on increasing the percentage of board members not directly tied to management and ensuring that such outside nonexecutive board members chair subcommittees—including those on financial reporting and compensation—where there are bound to be conflicts of interest between management and investors.

The Organisation for Economic Co-operation and Development has recently promulgated international corporate governance standards. Active debates focus on whether it should be left to firms to adopt such practices on their own, whether this should be encouraged through required disclosure of actual practices, or whether the adoption of certain practices should be mandated. In Germany, for example, the corporate law specifies the composition and authority of the supervisory board.[42] The United Kingdom has set up a voluntary system of disclosure. Evidence indicates that this has led to large changes in board structures; elements of this standard-setting approach have been followed elsewhere.

But in most developing countries a lack of mechanisms to enforce adherence will limit the impact of such standards. In practice, even in industrial countries it is difficult to find systematic evidence linking the adoption and use of independent boards to improved firm performance.[43] If the board members are truly outsiders, they face difficulties in monitoring management, as they are often dependent on management for the provision of information. And even if they have the information, they may lack the expertise, the time, and the incentive to monitor management actions.

These problems are magnified in developing countries. The vast majority of large firms in developing countries have concentrated ownership structures with a controlling shareholder, often a member of a business group. The controlling shareholder can dominate the board selection process, particularly when there is no cumulative voting. This makes it unlikely that board members will be independent. Added to these problems, public information flows in developing countries are weak. An independent director relying on these information flows would have difficulty performing a monitoring role.

All this is not to detract from the potential value of independent boards. But as long as enforcement is weak and little public information is available, the traditional boards dominated by those with a relationship with the firm, such as buyers, suppliers, and stakeholders, may be in a better position to improve the functions of governance. Policymakers interested in improving governance have to do more than impose obligations on companies to produce board structures that comply with standards, such as independence. Where steps are taken to improve information and enforcement, board reforms will complement these changes.

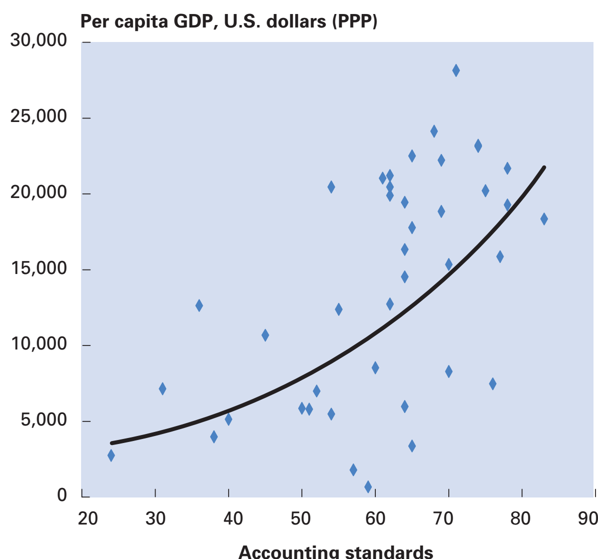
Institutions that provide investors with information

In formal corporate governance systems, laws and boards create potential limits to the diversion of resources. But investors also require timely, accurate, and reliable information on which to base their decisions. Empirical evidence indicates that the quality of information available helps explain the wide cross-country differences in the sensitivity of investment to value added. Better-quality information is associated with firms making more investments in high value added activities.[44]

Firms in developing countries provide and have access to often limited information of relatively poor quality. An accounting benchmarking study has compared national statutory accounting standards with international accounting standards to provide one index of cross-country differences.[45] Although this is an imperfect measure that does not capture differences in lapses in enforcement, the results are nonetheless revealing (figure 3.4).

A study following the East Asian financial crisis provides evidence on the extent of information gaps. It found that more than two-thirds of the largest publicly traded banks and corporations produced financial statements with little relation to international accounting standards. Table 3.2 shows that weaknesses in accounting standards included lack of disclosure about transactions in which the manager or entrepreneur had

Figure 3.4
Accounting standards across countries



Note: The figure shows a scatter plot of the relationship between an indicator of accounting standards and GDP per capita.
Source: Center for International Financial Analysis and Research (CIFAR), cited in La Porta and others 1998.

Table 3.2
Financial statements do not disclose useful information for resource providers

International accounting standard category	Percentage of firms in compliance
Related party lending and borrowing	30
Foreign currency debt	37
Derivative financial instruments	24

Note: Sample includes 73 of the largest publicly traded banks and corporations in Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand.
Source: Rahman 1998.

an identifiable conflict of interest, as well as widespread lack of disclosure of liabilities. One of the most surprising findings was that this lack of disclosure took place despite the involvement of auditing firms affiliated with the top international firms and in many cases was perfectly legal according to national standards. Although not the primary cause of the crisis, poor information was a contributing factor to the crisis. Investors who relied on publicly available information were in a weak position to identify bad practices and therefore to protect themselves or to distinguish between good and bad investments.

The ability of brokerage houses to estimate accurately the earnings of large publicly traded firms provides another indication of the information challenge. It also illustrates the extent of the difference between countries with strong regimes for producing information and those with weak regimes. A recent study measures the average forecast error between the earnings estimates of financial analysts and actual earnings as an indication of this challenge.[46] Countries with the lowest forecast error included the Netherlands and the United Kingdom, while countries with the highest forecast error included China and Mexico. Institutional differences across countries, including the extent of accounting disclosure, help to account for these differences. Most firms are neither large nor publicly traded, particularly in developing countries. But where information flows are distorted for these firms, the challenge for those trying to evaluate smaller firms that are not publicly traded is significant.

In some countries, private actions to improve information quality developed before public steps, with private organizations stepping in to satisfy the growing demand for information. In other countries, governments have played a more prescriptive role (box 3.6). In the United States, for example, auditing and bond-rating firms developed because of rapid growth and rising need for external capital, starting with the railroad companies. Private and public actors played complementary roles.

Private initiatives provide only limited incentives to entrepreneurs to disclose information. They were also not standardized. Entrepreneurs have the incentive to reveal information about good projects but to hide information about projects with poor returns. In essence, the purchaser of the service (the company) is not always the party with the greatest interest in obtaining high-quality audit services. Measures such as audit committees and nonexecutive directors can be adopted to better align the interests of auditors and managers. But risks of incompetence and the possibility of collusion with management remain.

In countries where the setting of accounting standards was initiated by the private sector, the state has intervened. Standards and requirements issued by the

Box 3.6

Limitations to private governance in accounting

With the emergence of the joint stock company, financial reporting became an important instrument of corporate governance. Financial reporting made managers account for the use of the capital provided by owners. The audit also emerged as a tool so that an independent expert could provide assurance to the owners about the completeness and reliability of the information provided by the managers. Previously, when the number of parties involved in an enterprise was small, a contractual approach was adequate, and the need for external regulatory intervention was limited.

In the countries with a common law tradition such as the United Kingdom and the United States, a self-organizing profession of accountants emerged, starting in the mid-19th century. This gradually built up a body of commonly accepted practices for auditing and preparing accounts. These were accepted voluntarily by enterprises and did not initially require legal backing to enforce them. Over time—and often in response to corporate collapse or scandal—legislators intervened to address coordination problems. These problems arose from several factors: the presence of large bodies of shareholders who negotiated accounting and auditing arrangements on a contractual basis with management; the absence of legal authority on the part of the accountancy profession to oblige enterprises to follow their rules; and the losses caused to third parties—for example, to creditors in cases of insolvency—who were not privy to the contractual relationships among owners, managers, and auditors.

Initially, the elaboration of many of the detailed requirements (such as accounting standards) was left to the accountancy profession. Over time, legislators and regulators gradually took control over setting standards in the area of accounting, auditing, and ethics and exercised greater influence over the requirements for entry to the profession as well as members' accountability. This turned professional bodies from self-regulating organizations, exercising delegated regulatory authority over their members, to organizations exercising authority delegated from the state.

For countries with a Roman law tradition, the pattern of evolution has been different. In countries such as Germany and France, legislation establishing joint stock and limited liability companies was much more prescriptive in terms of detailed accounting and auditing requirements. In addition, many of the requirements were directly responsive to the needs of the state as user of financial information—for example, the influence of taxation rules on general purpose accounting requirements. Further legislation did not confer regulatory authority on preexisting, voluntary, self-regulating groups but instead established public law bodies to govern the profession. Access to the profession was controlled by state examination, judges were involved in disciplinary matters, and the activities of the bodies—for example, in representing the private interests of their members—were clearly circumscribed by law.

Despite their quite different origins and development processes, these two separate traditions for regulating accounting and auditing have converged to a significant extent. These two experiences also highlight different paths that developing countries today may take.

Source: Hegarty 2001, *World Development Report 2002* background paper.

profession were not perceived to be adequate to prevent failures or abuses, to ensure that its members properly complied with those requirements, or to guarantee that all interested parties had appropriate input to the development of those standards. But if standards are set by the state, there is a danger that the information sought by policymakers, with their interest in taxation, may be very different from the needs of investors. Private input into standard setting can help ensure that there is enough innovation to meet business needs.

Governments also need centralized and accessible share registries and property registries, which facilitate independent collection of information and verification of information produced by the company. Laws on disclosure increase information flows. An independent auditor's job is to offer judgment on whether the financial information made available to investors fairly represents the performance of the company according to the accounting standards. Since the users of the audit report may include stakeholders that were not involved in the negotiation of the audit contract, all industrial economies have legislative or regulatory requirements for audit to protect stakeholders—although the scope of these requirements can vary in response to other public policy considerations. For example, it is common to exempt firms below a certain size from audit requirements because of the limited use made of their accounts.

As international transactions have grown in scope, there has been an increase in demand for the standardization of information across borders. In response, an International Accounting Standards Committee (IASC) was established in 1973 and produced International Accounting Standards (IAS). Large firms have voluntarily adopted these standards to gain access to international capital markets. For small and medium-size firms however, these standards may not be appropriate because they are explicitly shareholder-oriented and because the

Box 3.7
Evolution of international accounting standards

Since the early days of the International Accounting Standards Committee (IASC), certain small or developing countries have chosen to adopt International Accounting Standards (IAS) as their national standards rather than incur the expense of developing their own local standards. But it was soon accepted that the full benefits of IAS would accrue only if they were accepted for use by larger, internationally active companies, especially for purposes of raising capital across borders. IASC therefore began to focus on producing standards that would meet the information needs of investors in listed companies and on seeking recognition for those standards from the securities market regulators responsible for determining the conditions—including those on financial reporting—to be met by companies seeking to be traded on their markets. Steady progress has been made and, except in the United States and Canada, all the world's major securities markets accept—for regulatory purposes—financial statements from companies registered abroad that are prepared in accordance with IAS.

In May 2000 IOSCO, the international organization of securities market regulators, officially endorsed IAS subject to certain conditions. In June the European Commission announced its intention to propose legislation that would make it mandatory for listed companies to use IAS in their consolidated financial statements by 2005, at the latest. This legislation was published in February 2001. However, the remainder of the approximately 4 million enterprises subject to other EU accounting legislation is exempt.

Source: Hegarty 2001, *World Development Report 2002* background paper.

requirements of IAS are complex and would be too costly for small and medium-size firms to adopt (box 3.7).

For countries considering accounting reform, the first lesson is that one size does not fit all, and there can be a strong argument for having different financial reporting regimes for different categories of enterprises. Multiple regimes can impose costs, but these need to be weighed against the benefits. At least two distinct categories can be identified:

- For companies seeking to raise capital on the market, and especially those seeking foreign investors, IAS are now recognized as the international accounting standards. It is essential that these companies be permitted to use "pure" IAS, since any modification to these standards means that the resultant standards cannot claim compliance with IAS. As the Asian crisis showed, involving local affiliates of international auditing firms is not sufficient to enhance information quality because the affiliates tend to follow national standards.
- For other companies, however, the use of IAS may be excessively burdensome or inappropriate in light of their stakeholder or user groups. Simplified accounting and reporting requirements, which respond to the information needs of the taxation authorities, may be more appropriate. But care should be taken not to allow the needs of one user group to distort the accounts, since they would cease to be relevant for other users, including management. Specific needs of individual users can be addressed through supplementary reports based on, and reconciled with, the general-purpose accounts.

The nature of the information provided and demanded is affected by the nature of the users and providers. Along with government, financial intermediaries—including pension, mutual, and hedge funds—create a demand for added information and analysis. Information intermediaries, such as bond-rating agencies and financial analysts in brokerage houses, combine the audited financial statements with other sources of information and offer judgments about a firm's prospects. The financial press is yet another institution that can collect and disseminate information (chapter 10).

Incentives for intermediaries

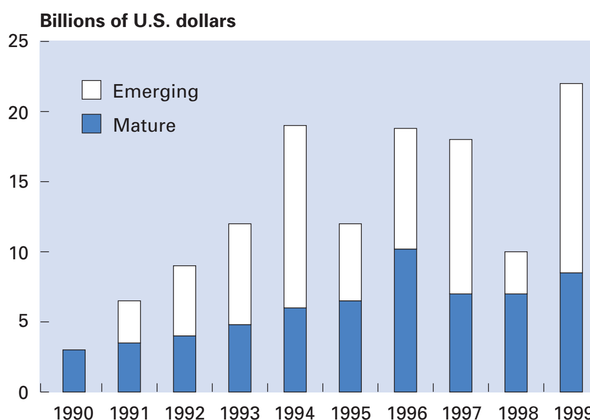
Mechanisms are needed to ensure that organizations involved in collecting and offering judgments on the quality of financial information are accountable both to the users and to the providers of information. There are many potential conflicts of interest. An auditor, for example, might own equity in or provide added services to the same firm for which it provides audit services. A brokerage house might provide investment banking services to a company covered by its financial analysts. Information intermediaries might have higher returns from engaging in insider trading or manipulating stocks than from providing quality information.

What produces incentives for intermediaries to provide timely, accurate, and reliable information? Among the forces providing pressures for efficiency are competition, reputational effects, and penalties imposed by a regulatory authority. Policies that influence the supply of firms seeking external capital and the extent of institutional investors increase the demand for information and are likely to sharpen the incentives provided by rep-

utation and competition. Openness stimulates demand further, allowing domestic firms to list on foreign exchanges and reducing restrictions on investments by foreign institutional investors.

The experience of the industrial countries suggests that relying solely on private institutions is not a sustainable approach. Given the substantial fixed costs and time needed to develop publicly available information flows, developing countries need to consider alternatives. One approach, discussed in chapter 4, is to focus on banks and private information flows. Another alternative is to allow domestic companies to engage foreign information intermediaries by cross-listing shares on a foreign exchange, where disclosure requirements are stringent, or to participate in international bond issues. The experience of large Chinese state-owned companies, which have sold a minority of their shares to investors through offerings on the Hong Kong stock exchange and the New York stock exchange, shows both the potential and the limitations of such an approach. Beginning in the early 1990s, firms from emerging international markets have tapped this market, accounting for a majority of dollars raised in recent years (figure 3.5). Privatized companies account for more than one-third of this revenue.[47] But the significant costs associated with complying with listing requirements means that this option is available only to a few large firms. Moreover, the problem remains that investors must still seek redress in the firm's home country, which may lack laws to protect investors or enforcement mechanisms.

Figure 3.5
Capital raised through new depository receipt programs



Source: IMF, 2000.

Conclusions

Institutions which affect the governance of firms are important for determining how resources are allocated, and who has rights over resources, both within countries and between countries. Therefore, they affect growth and poverty reduction. Governance institutions for small and large firms differ. Large firms are few in number relative to small ones. However, on average they account for a significant proportion of value added and employment. Moreover, weak governance in these firms has been associated with financial and economic crises, which can have severe consequences for poor people. But when these firms do well, they contribute significantly to growth and have a direct impact on the lives of people. Powerful incumbent firms also have an incentive to prevent changes in institutions that may reduce their gains and have often opposed policies that facilitate entry of new firms. Actions can be taken to limit these incentives. Such pressures have existed in the development experience of many nations, but successful development initiatives have sought to balance the gains that large firms provide with the negative effects on policies towards new entry and change.

But in most developing countries, another kind of problem is prevalent. And that regards the relation between the state and private business. In poor countries there are often few limits on state arbitrariness; that is, public officials themselves are not bound by the laws which they adopt, and do not keep their established "contracts" with private agents. Often, there is also weak contract enforcement between private agents and poor information provision. These problems hinder new entry into the formal sector. In these contexts, private institutional approaches will continue to dominate; they will substitute for the lack of effective formal publicly provided alternatives. In these circumstances policymakers will benefit from being open to innovative approaches by private agents.

Openness to trade in goods and services and to information sharing can increase the efficiency of such private mechanisms and can promote further institution building by creating forces for change. Formal governance institutions can offer long-term benefits to complement private initiatives. Such institutions increase opportunity for firms, and by promoting invest-

ment in high value added activities, they enable growth of firms and employment within firms. They support increased economic growth and poverty reduction. There are often large obstacles to the development of laws and internal governance institutions, and to regulatory agencies. New initiatives in institution building need to complement and build on existing institutions. For example, adopting laws which require regulators to have extensive information on firms may not be a priority without prior attention to building information flows, such as those which accounting systems provide. Policies that help to build political support for governance changes, such as openness in trade and in transparency or open information sharing among the different parties affected by reforms, are as important as the specifics of individual reforms.