A New-Institutional Economics Perspective of Corporate Governance Reform in East Asia

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In this brief paper, we demonstrate that corporate governance structures as well as the distinct roles of government and private corporations in economic systems may be propitiously modeled from the new-institutional economics perspective. Our theoretical model and analysis leads us to strongly suggest that East Asian governments limit the scope of public policy so as to determine the institutional environment for corporate governance structures while leaving the details of internal control systems to be decided upon by the corporations in the pursuit to maximize their survival probabilities. Furthermore, for good corporate governance in this part of the world, not only the internal control systems but even more urgently the external control mechanisms, should be firmly established and strengthened, without losing sight of the prevailing economic and cultural values.

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I. The East Asian Financial Crisis and Corporate Governance

Many East Asian countries, Korea included, suffered immensely

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from the 1997 economic crisis despite sound "fundamentals" prevalent at the time, in particular the relatively high growth rates coupled with low inflation. Many economists and scholars have suggested various reasons for the causes of the crisis, which have cumulated into the numerous arguments to be found in the literature. Since it is said that no two economists agree, it may be safe to claim that a consensus about the causes of the crisis may not arrive any time soon. Nevertheless, it is our contention that poor governance of corporations and financial intermediaries was indeed one of the most critical factors behind the crisis.

It is important that the structural problems behind East Asia's economic crisis should not be interpreted as being country-specific. There are certain common properties shared by East Asian countries that have shaped the type of corporate governance systems in place. East Asian countries are characterized by the prominent role of government intervention in economic decision-making, and as a result, institutional infrastructure such as the market monitoring and disciplinary system is usually not sufficient, and investors and market participants tend to be free from competitive market pressure. Furthermore, their common social values that derive to a large extent from Confucian Asian values have contributed to the evolution of the current corporate landscape. We observe that Confucianism has often served as the philosophical basis for our paternal governments, because it emphasizes that an elite group of morally superior men should lead the "morally inferior" general public by using principles and rules that they themselves have chosen. It cannot be denied that past government-led economic management based on Confucianism has contributed to the rapid growth of East Asian economies, but it is important to note that it has resulted in more regulations and restrictions on economic activity than in Western countries. Moreover, the emphasis on an elite group as a leading social force has led to non-transparent business as well as national governance structures that have relied on a group of elite's, or the president or chairman's, discretionary decisions rather than on market discipline based on the rule of law. It may, therefore, be said that most East Asian economies face similar economic problems in that they share similar structural and institutional burdens that are in need of urgent ramification particularly during this post crisis period.

Good corporate governance can be seen as having important implications that foster the performance of a firm, and therefore a proper understanding of the structure of relationships and corresponding responsibilities among shareholders, board members, managers, and other stakeholders cannot be overemphasized. Corporate governance matters in that it has real impact not only on the managerial efficiency of a corporation but also on the performance of the national economy. Corporations with poor governance structures will have difficulty accessing capital markets for funds, particular in this important era of globalization, and will thus eventually lose to competitors. From a macroeconomic perspective, the financial crisis in Asia has given us a highly visible demonstration of the importance of a sound governance structure. Corporate governance reform is, however, a highly complex subject having no quick-fix methods. A well-thought out approach to addressing the current problems in corporate governance is essential to uproot the structural and, as we shall see, more importantly, institutional problems that led to the recent financial crisis.

II. New-Institutional Economics Perspective

New-institutional economics derives from work by Coase (1937, 1960), Alchian and Demsetz (1972) and more recently Eggertsson (1990) and North (1990). It is distinct from traditional neoclassical economics in that the existence of non-zero transaction costs is emphasized in their understanding of the real world economy. In a non-zero transaction cost world, economic institutions become the ultimate determinant of the size of transaction costs influencing the structure of economic organization and performance. Hence, a key concept in this modern approach to economic analysis is the importance of economic institutions in determining economic behavior, organizational structure, and business performance. That is, the type of economic institution built into the economy becomes a most crucial factor in determining not only the nature of economic organization but also the performance of the economy in general.

To see this aspect more clearly, it is useful to distinguish among three different levels of an economic system (Eggertsson 1990). An economic system can be described as consisting of individual economic agents, economic organizations which organize individual

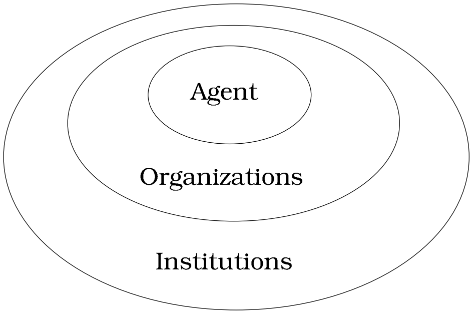

FIGURE 1
CONSTITUTION OF AN ECONOMIC SYSTEM

agents, and finally economic institutions which regulate the agents and organizations (see Figure 1).

According to this classification, one can distinguish three different levels of economic analysis of an economic system. The first and most simple level would be to analyze the effects of the given structure of economic organizations and the given type of economic institutions on the economic behavior of individual agents. The second and intermediate level would be to analyze the effects of the given types of economic institutions on the structure of economic organizations. Lastly, the most comprehensive level of analysis would be to treat economic institutions as endogenously formed and to explain how the institution evolves through various political processes. In this level of analysis, economic agents and organizations are treated as the players who take the initiative in changing the existing institutions for their own advantages.

This analytical framework of new-institutional economics can readily be applied to our discussions on corporate governance as will be done shortly. The aim of this paper is, however, not only to spell out the relevancy of the new-institutional economics perspective to corporate governance but also to lay down its path to reform. This is the realm of public policy, and it is important from the outset to define clearly the different actors and their roles in corporate governance reform.

III. Role of Government in Corporate Governance Reform from the Perspective of New-Institutional Economics

In approaching issues of corporate governance reform, the distinct roles of the government and markets in disciplining corporate governance must be redefined. As is well known in this part of the world, the government has often directly intervened in the decision-making process of the private sector, thereby creating undesirable distortions in the economy's incentive structure. So, how should the role of government be defined so as to generate a viable business culture? Broadly speaking, the government should establish a regime of fair competition in the economic and social system so that the discovery function of the market order may become effective. Specifically, the role of the government should be limited to defining the external economic and social environments, and should be confined to preserving the spontaneity and endogeneity of the market order. What is important here is the distinction between exogenous and endogenous economic variables. The government should create an economic environment conducive to active competition in the market by providing proper economic institutions, that is to say, the rules of the game, which to the firm, constitute the exogenous variables, while allowing endogenous management decisions to be independently decided upon by private corporations. This is in essence the important implication derived from the new-institutional economics perspective summarized in Figure 1.

In sum, to a business firm, which may be either a single agent or complex organization in an economic system, the external market environment is an exogenous variable while internal control systems are strategic variables disposable to the management, and is therefore endogenously determined. As is well known among economists, we must bear in mind that the optimality of endogenous behavior is conditional on the effectiveness of exogenous market pressure. Therefore, non-optimality, if any, with endogenous corporate behavior may be due to the ineffectiveness of market pressure. Then, if we wish to improve the corporate behavior including the internal control mechanisms, we must first aim at improving the market discipline to corporations.

IV. Corporate Governance Reform

From the discussion above, Figure 1 may be re-interpreted and applied to the context of corporate governance as shown in Figure 2. Here, corporations as economic agents or organizations can be regarded as being disciplined by the prevailing institutions, which set the rules of the game. This institutional environment can be depicted as consisting of two ways to monitor and discipline corporations, namely through external market mechanisms and through internal control systems. The external market mechanisms are the exogenous factors affecting business decisions, and usually emphasize the establishment of economic institutions to enhance the corporate monitoring role of the various markets for products, capital, debt, managers and so on. Internal control systems, on the other hand, constitute endogenous variables, and include mechanisms such as the holding company system or a planning and coordination office operating as a kind of holding company, as well as the board of directors.

The board of directors has a unique role in a corporation. On the one hand, the board of directors can act as a signaling mechanism to potential investors, shareholders and stakeholders, consumers, producers and other interested parties about the type of management strategy that the corporation has adopted. Therefore, the determination of the board of directors should be left to the discretion of the corporate management as an essential part of the management decision variables. On the other hand, since it is composed of agents who represent various interests groups including the shareholders as well as stakeholders, the board of director acts as a window by which these external groups may directly influence the management of the corporation. As such, the board of directors acts simultaneously as part of the external and internal control system for corporate governance. From this, we learn that the nature of the board of directors is a delicate and critical matter. Economic policy and government action, therefore, must refrain from putting too restrictive constraints by regulating the composition and operations of the board of director. Rather, the management's autonomy to utilize the board of directors as an important strategic variable should be respected. The role of government and public policy is therefore to promote the effective

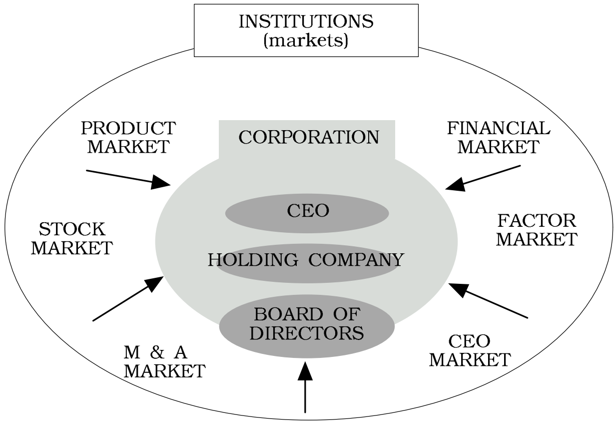

FIGURE 2

CORPORATE DISCIPLINARY SYSTEM

functioning of external market mechanisms through institutional reforms, which will help discipline corporations, while leaving the details of internal control systems to be decided upon by the corporations in the pursuit to maximize their survival probabilities.

Current debate about corporate governance tends to put more weight on internal control systems as can be seen in the OECD guidelines (OECD 1998), which emphasize the proper role of the board of directors in corporate governance. This, however, is largely based on the experiences of advanced economies in which the external market for corporate control in the product, capital, debt, and CEO markets are well established and all operate competitively. The situation in East Asian economies is somewhat different owing to the past interventionist development strategies that have hampered the development of various market institutions. On top of that, the OECD position seem to miss the point because they fail to recognize, as mentioned above, that the system of the board of directors is in fact part of the internal management system, which should be allowed to be strategically utilized to meet the objectives of the corporation, and ultimately the details of the internal management system should be left so as to be endogenously determined. Therefore, in the East Asian context, including Korea, it may be argued that the improvement of the role of the external disciplinary system becomes even more urgent and crucial in influencing corporate behavior, and in fact has deep repercussions toward enhancing the efficiency of internal governance systems, including the board of director system. In other words, not only is the continued development of internal control systems important, but external control mechanisms must be established and strengthened. Furthermore, there should be a conscious effort to avoid the possibility of imposing excessive restrictions on management decision variables that is likely to occur if we are not careful.

V. Conclusion

The role of institutions in the determination of corporate governance systems is of paramount importance and cannot be excluded from any realistic discussions on corporate governance reforms. This short essay has demonstrated that corporate governance systems as well as the distinct roles of government and private corporations may be propitiously modeled from the new-institutional economics perspective. It is recommended that the government limit the scope of public policy so as to determine the institutional environment, which set the exogeneous variables, while leaving the details of internal control systems to be decided upon by the corporations in the pursuit to maximize their survival probabilities. The dichotomy is, however, not that simple as may be seen by the discussions on the role of the board of directors. Our analysis shows that despite the deep concern by the OECD on corporate governance issues, their emphasis on internal disciplinary systems is somewhat misguided and can not succeed without first revamping external market institutions needed for proper reform.

Also as mentioned in the very beginning, East Asian economies are tied together not only by their geographic proximity but also by the philosophical orientation of their development policies, which have far-reaching implications on the evolution of institutions and corporate behavior, as well as the roles of corporations in society. Institutions include not only the formal legal framework but also the informal cultural aspects of a society that in turn help mold the type of institutions that evolve. That is, common cultural features, such as Confucian Asian values, constitute an important ingredient in the endogenous growth of institutions in the East Asian economies. Therefore, corporate governance reform and restructuring in East Asia will not succeed if it neglects the commonly shared cultural values as well as the unique characteristics of the individual countries economic environment. Only corporate governance structures best suited to a country's historical and institutional environment can remain competitive. As such, it will be naive to expect a universal ideal governance system. However, with the increasing importance of global markets, each country's governance structure must be compatible with regional as well as international standards, if it is to enhance economic prosperity.

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