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Economic analysis of corporate governance failures in emerging markets

Dr. Vivek Saurav
Assistant Professor of Law, SVKM's ASMSOC NMIMS (Deemed to be) University, Mumbai. E-mail: vivek.saurav@nmims.edu

Dr. Richa Kashyap
Assistant Professor of Law, SVKM's KPMSOL NMIMS (Deemed to be) University, Mumbai. E-mail: richa.kashyap@nmims.edu

Abstract
Corporate governance in the emerging markets is structurally, regulatory and behaviourally weak, eroding the efficiency of the firms and investor confidence. The article is an economic opportunity focused study on corporate governance failures in some of the emerging global economies including India, Brazil and South African markets. It also investigates how ownership structures, inefficiency by the boards, clash of agency as well as regulatory deficiencies aggravate governance risks. Using the examples of actual corporate corruption of Satyam (India), Petrobras (Brazil) and Steinhoff (South Africa), this research paper examines the economic implications of poor governance and suggests of reforms that will lead to more efficient market practices and protection of investors as well as corporate responsibility.

Introduction
Corporate governance (CG) can be defined as the measures, the proceedings and the relationships through which businesses and companies are controlled as well as being guided. It includes the regulatory environment, legal environment, institutional environment and ethical environment in which businesses are set within. Fundamentally, corporate governance exists to ensure a balance between the interests of all the stakeholders of a company, the shareholders, the management, customers, suppliers, financiers, the government and the community. Good governance promotes accountability, fairness, and transparency between a company in its association with these stakeholders.

Corporate governance failures may cause major implications. Across the world, scandalous corporate failures like Enron, WorldCom and lately Wirecard have shown how governance failure may cause it to lose money, credibility with investors, and face legal scrutiny and economic food chain threat. The consequences are worse typically in the emerging markets as the legal systems are weak, finance institutions have not developed fully, investor activism is less and corruption is more rampant. The corporate governance scandals involving Satyam Computers in India and Petrobras in Brazil have been high-profile in the emerging economies such as India, Brazil and South Africa, among others, that made investors to lose faith in the system and point at inefficiencies.

Economic analysis of corporate governance failures extends beyond determination of regulatory break or ethical lapse; it is a deeper look at, incentive structure, cost-benefit asymmetry, agency issue as well as the economic impact of corporate governance failures. The economic theory can offer principles like principal-agent models, transaction cost analysis, as well as game theory to learn how managers fail to act in the interest of shareholders, why boards can fail to provide oversight, and when auditors, regulators, or rating agencies will fail to act as desired.

Amid emerging markets, failure is usually compounded by centralised ownership patterns, political influence, absenteeism of the board and the enforcement of the prevailing legislation. The effects on the economy are not only at the organization level but extend to the economy in being very volatile, capital flight, and high cost of capital and diminution of growth in the economy. Besides, foreign direct investment (FDI) and international investor activity that is essential in development paths of such economies are thwarted by such failures. In such a way, this article covers corporate governance failure in the emerging markets in an economic perspective.

It gives some general trends, examines some important cases, and argues how weakening of institutions and mismatching of incentives have to do with the breakdown of governance. Also, the article suggests economically effective changes, based on the ramified experience in developed markets, however, without indignities on the local situation of developing markets. In this way, it will be able to develop an insightful reflection of the patterns of governance as well as a prospect to enhance the corporate accountability and the economic sustainability and growth.

1. Understanding Corporate Governance from an Economic Perspective

Corporate governance (CG) involves issues that comprise the interrelation of the interest of different stakeholders of a company in which, the interest of different stakeholders of a company, mainly, being shareholders, the management, the creditors, the employees, are aligned in an appropriate manner. Economically, CG covers the methods of how companies might be able to reduce agency expenses and how optimal allocation of resources and creation should take place. A number of economic theories form the basis of the dynamics of governance.

Economic analysis of CG focuses on the agency theory- It refers to the conflict between the principals (shareholders) and agents (managers) in a position of driving the firm with the owners. Such a conflict is caused by asymmetric information and variety of goals. Without the strategies being in place aimed at ensuring that there are proper governance mechanisms such as performance based incentives, independent boards and open disclosure practises, managers are likely to seek personal gains or at least short term gains rather than enhancing long term shareholder value.

Transaction cost economics, proposed by Oliver Williamson, says that governance structures keep changing in order to reduce transaction costs in the market, including the cost of negotiation, monitoring, and enforcing the purchase contracts. Companies respond to this by employing certain governance mechanisms in an attempt to reduce these costs and decreasing opportunism.

Ownership issues are brought out in the **property rights theory** that emphasises the structures of ownership in determining the incentives. Governance a factor in emerging markets high concentration of ownership, not just family owned companies but may also be state owned or operated by the promoters dwelling on the boards. Although concentrated ownership might minimize agency costs between managers and owners, it might increase conflicts between majority and minority stockholders thus resulting into such problems as expropriation of minority interests. This is worsened in the developing economies which are characterized by poor enforcement of the law, poor investor protection, and undeveloped financial systems. So, when the economic theories define CG, they provide a rational manner in which reforms in context can be made to increase firm accountability and safeguard investors besides providing sustainable economic development.

2. Characteristics of Emerging Markets and their Governance Structures

The main aspects of emerging markets are poor institution building, poor enforcement of the regulations and the development of the financial mechanisms, which greatly affect the corporate governance styles in these markets. Major setback is that there is a weak enforcement of law and there are limited measures that investors can seek redress to cases of conduct and fraud that may encounter minority shareholders.

Regulatory authorities will also lack sufficient capacity and are subject to political interference and corruption leading to lack of confidence and integrity in the fair administration of governance standards. Financial markets in such economies are less transparent, their disclosure norms are weaker, insufficient auditing practices and less examination by the people as compared to the developed markets.

Among the other characteristics of governance in emerging economies are large business groupings, e.g. family-motivated conglomerates in India and Latin America or chaebols in South Korea. Such groups usually have excessive control on policy, regulatory bodies and even financial institutions. On the one hand, they may be the source of stability and long-term orientation; on the other, they will be characterized by the risks of related-party transactions, insider control, and expropriation of minority shareholders.

Seven structural features are most important when it comes to understanding governance failures as well as building reform sensitive to local economic and institutional facts.

3. Economic Rationale Behind Governance Failures

The economic rationale behind corporate governance failure in the emerging markets is related to misaligned incentives, agency, and institutional gap. The main problem behind most failures is the problem of misaligned incentives especially when promoters or controlling shareholders are focused on personal benefits rather than value of the firm. Ownership structures are frequently concentrated in most of the emerging markets, which allows promoters to have a high level of influence on operations and policies of the firm. Such control may be misused to extract some personal gain, like diverting cash to related groups, selective contracts, or receiving disproportionate remuneration.

The other major issue is the expensive surveillance. There is a lot of asymmetry in information to both institutional and retail investors, the latter cannot access the real-time disclosures, and their shareholder activism options are also minimal. The stakeholders find it hard to monitor the firm in so far as financial statements are not easy to understand, and that is where independent analysis is usually lacking. This opens up managerial opportunism, and undermines market discipline further.

Another crucial problem is the incompetent board. Directors are frequently chosen on the basis of personal, or political loyalty, board members may not be independent, and they are not necessarily skilled. As a result, boards become rubber stamps instead of an effective watch dog. Also, the checks and balances are reduced by conflict of interest, mainly promoters being in the boards.

The situation is worsened by poor enforcement system. Non-compliance penalties in most of the new economies are weak and regulatory arbitrage prevails because most of the regulators are disjointed. It has the effect of providing a very low perceived cost of participating in unethical or illegal activities. In their application, governance codes have a tendency to be patchy or protracted regardless of whether they may have been developed or not. Moreover, the inefficiency in agency costs flourishes in such an environment. In absence of checks, managers can use the opportunity to look after empire building by investing in unaffiliated or risky ventures to maximize control, prestige or benefits at the expense of shareholder wealth maximisation. Such cases are also rampant with self-dealing transactions involving the benefits of insiders to the disadvantage of shareholders.

4. Notable Case Studies

Several real-world cases highlight how these economic rationales manifest into major corporate governance failures:

•**Satyam Computers (India):** One of the most famous IT companies in India was found guilty of overstating accounts amounting to more than $1.5 billion in 2009. The fraudster, Ramalinga Raju, admitted to massage the accounts to increase asset values and high profits. The board did not meet its fiduciary standard and PricewaterhouseCoopers, the external auditor was missing the obvious red flags. This case revealed the weaknesses of board independence, the diligence of the auditors and the internal control process.

•**Enron (USA):** Enron is an essential comparative investigation even though this is a developed market study. It had special purpose entities which it used to conceal debt and to inflate profits. Although the company had access to highly developed legal and financial systems, it demonstrates how the corporate governance can be compromised in the mature market when ethical principles are compromised, and where conflicted auditors (Arthur Andersen) collude with the management.

•**Petrobras (Brazil):** Lava Jato (Operation Car Wash) was a huge corruption scandal that showed how systematic the bribery and kickbacks between politicians and executives of a state run oil giant, Petrobras, were. It stressed the risks involved in state-owned ventures that are being led by state administration, particularly where state interest overrules corporate interest. Losses amounted to billions and this dented investor confidence on the performance of the Brazilian public sector management.

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•**IL&FS (India):** The Group IL&FS (Infrastructure Leasing & Financial Services), the largest non-banking financial organization failed in 2018 as a result of shortcomings in risk management, conflict of interest, and malfunctioning of internal controls. Regulators and credit rating agencies became inactive, despite numerous warnings and a collection of debt loads growing massively. This case highlighted the systemic risk that is posed to the wider economy by the mis-managed financial firms.

5. Macroeconomic Implications of Corporate Governance (CG) Failures

These corporate governance failures do not only cut then to individual corporations, but spread to a whole economy and particularly to those economies where the institutional structures are weak like in emerging economies. In a bad governance, there is an immense increment in the high cost of capital. There is a demand of risk premium on the part of the investors, especially, institutional, and international investors due to the absence of transparency, low enforcement of laws, and the risk of mismanagement or fraud. Such a high cost of capital applies a chilling effect to new investments and kills the growth in areas with high capital intensity (e.g., infrastructure and technology).

In addition, corporate integrity and regulatory accountability is a major indicator of foreign direct investment (FDI) in emerging economies: a vital growth stimulator. Investors are likely to lessen the amount of FDI inflows into countries that have had repetitive corporate governance cases or have weak regulatory systems that can be evident. International investors and multinational companies also choose jurisdiction, which will provide security language on the rights of shareholders, enforcement and credibility of exit.

Systemic risks can also be a failure of governance particularly when the firms are large or related. As an example, defaults or financial distress of major participants such as IL&FS (India) or other state-owned enterprises may lead to liquidity freeze and stress in the banking system and the spread of financial contagion. Such shocks obstruct the supply chains, erode credit markets and eventually lower the output of the economy.

Last, a series of failures lead to the only thing that can be destroyed, confidence among the investors, both locally and abroad. This erodes the credibility of capital markets over time, deters retail investor investing and leaves equity and debt markets without flourishing markets. This forms a vicious cycle that culminates in lack of trust, less investment, weak governance and non-prosperity in the economy.

6. Comparative Governance Indicators

The global benchmark tools, like the World Bank Doing Business Report, now discontinued but historically influential, and the Worldwide Governance Indicators (WGI), tend to exhibit such differences in the practices of corporate governance in the developed and emerging markets. Such reports always bring out the point that good corporate governance environments are developed in countries that have better rule of law, regulatory quality, and control of corruption. These jurisdictions tend to have better regulation of business, greater protection of investors and faster access to courts.

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As an example, nations such as Singapore, South Korea (after the Asian Financial Crisis reforms) and Malaysia have had their governance structure enhanced considerably via incorporation of shareholder rights, independence of the board as well as disclosure practice regulations. These gains have been associated with increased foreign portfolio investment, increase in GDP and the depth of capital markets. Instead, Nigeria and Pakistan, with weakly enforced laws and codes of governance and political intervention in economic regulatory mechanism, remain blighted with investor confidence and volatility of the financial markets.

Strength of governance is not just a legal and institutional problem but rather has direct consequence on macro economic stability. Those nations that have strong governance structures are likely to have lesser capital flight, more credit and lower borrowing cost, to the government and the private sector. Accordingly, the comparative indicators do not only act as a report card, but also a strategic policy compass.

7. Legal and Regulatory Gaps

Even though they have been increasingly incorporating modern corporate governance codes and frameworks, it has still shown that several emerging markets such as India still have extremely crucial legal and regulation gaps, which are frustrating their effective application. Lack of modern provisions of the company law in some jurisdictions is one of the major concerns. Even in reforming environments, like in India, reforms like the Companies Act, 2013, have huge delays in the implementation of the most important provisions, or knowledge gaps in interpretation among tribunals.

The second qualitative problem is an ineffective protection of minor shareholders. Although there are statutory remedies against the oppression and mismanagement (through sections 241-242of the Indian Companies act), these can hardly be successfully resorted to because of the tortuous process involved, the time delays in all courts and possible retaliation. Consequently, the interest of minorities gets trampled by the powerful promoters.

Such related-party transactions (RPTs) continue to present a challenge and there are cases of some firms practicing tunnelling of assets, transfer price adjustments or self-dealing. Uncontrolled such practices take the firm value to the insiders and demolish the trust of the shareholders. The regulatory tools, which exist in the form of SEBI or stock exchange, are reactive and rely on whistleblowing although media exposure-based regulations.

Moreover, the problem of judicial delays, in particular, corporate litigation serves as an impediment toward seeking redress. The tribunals such as the NCLT are overloaded, and the mechanism of enforcement is ineffective, resulting in the absence of the deterrent effect on the violators. The resultant net-effect is a governance format, which is powerfully constructed on paper, and woefully unproductive on the ground, hence reinforcing inefficiency at large and investor distrust.

8. Reforms and Economic Recommendations:

Corporate governance reforms are necessary in enhancing economic efficiency, investor confidence and the market integrity in general. In the new markets, the presence of institutional weakness in the markets is more present as well as the regulatory arbitrage; therefore, the adoption of effective reform programs is important. Among the recommendations are to enhance the functions of independent body of regulators like SEBI in India and CVM in Brazil. These institutions should have given enough independence, funds and powers to implement the regulations in a stable and coherent manner.

Reforms in boards are also necessary. Compulsory board appraisals have the capacity to make the directors not a scenery but an active member of the decision-making unit. Advancing the number of independent directors and women in boards is part of varied opinions and enhanced management. The directors can also be prepared to address the complex governance issues through a mandatory training.

The whistleblower protection legislations are important in the transparency of companies. A motivating and protecting whistleblower can decrease the level of fraud and misconduct by maximum. The countries need to implement viable structures that have a legal immunity but also encourage such whistleblowers.

The role of technological interventions is becoming more and more critical. Audit trails through blockchain can reduce the possibility of an obstruction in the financial statements, and AI tools can recognize the anomalies and trends in the type of fraud in real time. Digital platform use can increase visibility, limit human error or frailties, and give advancements to probable governance drops.

Regulatory agencies should introduce corporate governance scorecards and disclosure-based ratings that allow investors to make informed decisions to force companies to follow the best practices. The tools have proved to be accommodating in Southeast Asia and Africa. Generally, institutional, legal and technological corrections, with the power of political will, are needed to establish a flexible corporate governance system in developing markets.

9. Role of International Institutions and Cross-Border Influence:

International institutions have become critical in international governance and in particular control measure in emerging markets. The OECD Principles of Corporate Governance are generally seen as a global standard setting, which affects the national frameworks and expectations of investors. The principles focus on transparency, accountability, fair treatment of shareholders and the roles of the board.

Governance related conditions to financing are common in the work of the World Bank, IMF and IFC (International Finance Corporation) particularly in their funding programs to developing countries. By way of example, IMF structural adjustment plans or World Bank aid schemes normally hold the condition that the beneficiaries qualify to boost their legal and institutional frameworks to facilitate corporate governance changes.

Moreover, the development of Environmental, Social, and Governance (ESG) investing has also contributed to the great extent of cross-border impact on the standards of corporate governance. Even foreign jurisdiction is witnessing these large institutional investors such as BlackRock and

Vanguard demanding better governance in terms of proxy voting and shareholding activism. The non-compliant with the global ESG standards firms may marginally experience capital flight or discounting of their values.

Moreover, stock exchanges and financial regulatory authorities are demanding such international CG norms as Cross listing or foreign portfolio investment. Example: Indian companies, which go for listing in the NYSE or LSE, have to meet very high level of governance norms more than the local laws. Overall, the international governance system has a significant impact on the domestic CG practices based on the regulatory harmonization, investment conditionality, and market-related pressures. Bringing local standards in line with the global best practices does not only seem desirable but it is also a prerequisite to attract long-term finance and promote sustainable economic development.

Conclusion:

Economic study of corporate governance (CG) breakdown in the emergent markets reveals a triple bind among the institutional weakness, a mismatch of incentives and endemic regulatory sluggishness. In comparison with developed economies with the well-developed institutions and well-established enforcement procedures, emerging markets are associated rather frequently with the low level of consistency in legal enforcement, the problematic independence of the board of directors, and the underdeveloped state of investor protection. These weaknesses in governance also do not limit the efficient allocation of capital but also increase the cost of capital, de-motivate long term investment, and create distrust with the financial system.

The implications are not limited to the inefficiency at the firm level. The misuse of governance may result in macroeconomic imbalance as well as loss of confidence of domestic investors, foreign direct investment loss, and flight of capital. Scandals like the Satyam, IL&FS or Petrobras have showed the way in which uncontrolled risks of governance can lead to the crisis with systemic consequences.

So corporate governance reform is not only a legal issue, but it is an economic issue as well. Engines of market-based forces such as ESG investing, institutional activism and greater disclosure norms, and robust law reforms and capacity building regulatory regimes are essential. Emerging economies need to rely on corporate governance as one of the pillars of their development strategy. The long-term economic resilience and sustainable economic growth are only attained when there is a credible and enforceable governance regime as such regime promotes not only accounting and transparency but also long-term economic resilience and sustainable growth in a fully integrated world market system.

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