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Context Matters: A Critique of Agency Theory in Corporate Governance Research in Emerging Countries

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ABSTRACT

This paper aims to provide an overview of the trend or focus in the research of corporate governance in emerging countries with the aim to identify the gaps in the existing literature. The review notes that corporate governance research in emerging countries is dominated by economic perspective, in particular the agency theory, as researchers follow the strands of research conducted in the more advanced countries, especially the US and the UK. This paper argues that although influential, agency theory is unable to provide sufficient understanding on many issues related to practices for the fact that corporate governance is not happening in social vacuum; it is affected by various other institutional factors and local context. Hence, in order to gain better understanding of corporate governance in emerging countries, alternatives perspectives or theories, such as institutional theory, should be employed by the researchers.

Keywords: Corporate Governance, Developing Economies, Agency Theory, Institution
JEL Classification: M41

1. INTRODUCTION

The purpose of this paper is to provide a commentary on the nature of existing research on corporate governance in emerging countries and to show how alternative theories are needed to gain deeper understanding of corporate governance in these economies. Corporate governance research in emerging countries is considered as relatively new as compared to those conducted in the more advanced economies. In the US, although corporate governance systems have long existed in their corporate world as evidenced by the work of Smith (1776) and Berle and Means (1932), the expression only started to appear in American law journals in the 1970s. It was then imported to the UK and has become widely discussed in the last two decades in both countries (O'Sullivan, 2000). By the late 1990s, it had become a major issue in all other advanced economies and, increasingly, in developing countries as well. Corporate governance became increasingly important in these developing countries due to privatisation, pension deregulation, free capital movement or capitalism globalization, market integration, and corporate scandals (Becht et al., 2005).

A review of existing literature on corporate governance in emerging countries suggests that they are mostly mirrored those conducted in the US and UK, focusing on the issue of agency problems. However, this paper argues that context matters; hence, research in emerging economies should utilize different theoretical perspectives in studying corporate governance due to the differences in their institutional contexts, politics, history, ownership structures, and other relevant factors. Agency theory is developed in the US and the UK due to their corporate structures characterised by the widely dispersed ownership. Emerging countries, however, do not share the same ownership structure. Hence, focusing only on agency theory would hamper the understanding of corporate governance practices in these economies.

This paper is structured as follows; the next section provides a brief discussion on various meanings of the term corporate governance. This is followed by a section that provides a review of corporate governance research in emerging economies. The focus is then shifted onto discussing the limitations of agency theory

when applied in the corporate governance research in emerging economies; followed by a concluding comment.

2. CORPORATE GOVERNANCE DEFINED

Corporate governance is an ambiguous concept. Basically, there is no one generally accepted definition of corporate governance; it differs depending on an individual's view of the world. Among the well accepted definitions developed by relevant institutions include the definition that "corporate governance as the system by which companies are directed and controlled" (Cadbury Committee Report, 1992); and corporate governance as a set of relationships between a company's management, its board, its shareholders and other stakeholders that provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined (The OECD, 2004).

Researchers define corporate governance according to their research perspectives. Schleifer and Vishny (1986), for example, looked at corporate governance from the agency theory perspective and defined it as "the ways in which suppliers of finance to corporations assure themselves of getting a return to their investment." However, Bradley et al., (1999) argue that corporate governance is more than simply the relationship between a firm and its capital providers. The broadest definition of corporate governance is given by Blair (1995. p. 3), who sees corporate governance as referring to "the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated." The following section discusses corporate governance research and adoption of codes of best practices in emerging countries.

3. CORPORATE GOVERNANCE IN EMERGING ECONOMIES

Historically, corporate governance research could be said to be originated from the US. The concern related to corporate governance in the US has existed for many decades ever since joint stock companies moved into the mainstream of global economy; particularly with the issues of inefficiency and corporate failures (Smith, 1776). An influential work by Berle and Means (1932) revealed that, despite their benefits the structure of modern companies in the US, characterised by a separation of ownership and control, had engendered a situation where the true owners of companies, the shareholders, had little influence over the companies' management. They wrote that:

> *"The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear"*
>
> (1932. p. 6).

This situation formed the basis of the agency problem, where managers may not act in the best interest of owners due to differences in motivations. Principals, therefore, struggle to control and monitor the activities of the agents. The study by Jensen and Meckling (1976) then shed light as to how companies could survive this agency issue. Since then, research on corporate governance has flourished in the US with agency theory been dominating the field.

It was only in the 90s that research utilizing non-US data started to appear; labelled as the first generation and second generation of research (Denis and McConnell, 2003). The first generation of research refers to those patterned after the US research that preceded it, in particular, board composition and equity ownership. Research efforts had started in three advanced economies, i.e., UK, Germany, and Japan; followed by other advanced economies, especially in Europe. The second generation of research considers the possible impact of differing legal systems on the structure and effectiveness of corporate governance and compares systems across countries. The attention to legal systems in corporate governance studies begins with the study conducted by La Porta et al. (1998), which investigates how the existence of laws protecting investors and the quality of enforcement of the laws determine corporate ownership patterns in a country. Research in emerging economies follows the first generation strand; appearing after other advanced economies. Therefore, these researches mirrored those conducted in the US and the UK, focusing on the issue of agency problems.

At the national level, corporate governance in emerging countries started to become important when they were experiencing changes in their domestic economies, which have led them to undertake market-oriented economic reforms in the 1980s and 1990s. This saw them implement widespread privatization, liberalization of economies, as well as expanding market institutions, such as the stock markets. However, the 1997/1998 Asian crisis, as well as few other crises in other emerging economies, allegedly due to weaknesses in their corporate governance systems, had then made corporate governance not only a national concern for these countries, but also a concern at the international level due to its spill-over effects (Singh, 2003). Adoption of codes of corporate governance from the Anglo-Saxon system became widespread. Attention then led to increasing research being conducted post-Asian crises, as more resources were being outlaid by international financial organizations to finance research in these economies.

Review of corporate governance literature in emerging economies shows few streams of research been conducted in these countries. One stream of research has been focusing on corporate governance mechanisms from the agency theory perspective including studies on privatization and agency issues (Dharwadkar et al., 2000); the role of ownership structure and investor protection in post-privatization companies (Boubakri et al., 2005); shareholder activism (Sarkar and Sarkar, 2000); and comparative studies of ownership structure and firms' performance (Claessens and Fan, 2002; Lemmon and Lins, 2003). Another stream of research focuses on the adoption of the corporate governance codes of best practices by the emerging economies from the more developed nations, in particular, the Anglo-Saxon system (Young et al., 2008; Singh et al., 2005; Aguilera and Cuervo-Cazurra, 2004). There are also works that have focused on government intervention

(Boubakri et al., 2005; Fan et al., 2011). Government intervention is one of the key institutional forces in emerging markets that impact upon the structures and behaviours of firms (Fan et al., 2011).

The review of corporate governance literature above shows that although attention has later been directed towards institutions, these studies are still based on agency theory perspective which focuses on corporate governance as mechanisms to address the agency conflicts. There appears to be lack of studies utilizing institutional perspective and gives evidence on how various institutions constraint corporate governance actors' actions. The next section provides some arguments on why agency theory is not sufficient to study corporate governance in emerging countries.

4. A CRITIQUE OF AGENCY THEORY

The flaws of agency theory in explaining corporate governance mechanisms, in general, are noted by Professor Victor Brudney (1985) when he argues against the analysis that claims that private bargaining or contract sufficiently restraints management misbehaviour. Acknowledging instead on the importance of institutions, he argues that:

> *"Scattered stockholders lack the requisite information and institutional mechanisms either to bargain over the terms of management's employment, or to monitor and control management's activities. The "markets" for managers and for securities do not effectively implement investor constraints on management. Outside directors are insufficiently independent from management to serve as agents for stock-holders in selecting or controlling management, and too many factors, and possibly information imperfections, affect the price of stock for it to serve as mechanism for effective investor impact upon managerial performance.... realistic inquiry into the operation of institutional factors affecting corporate governance is required before accepting approaches which are based on the rhetoric of "contract" and agency costs and reject the need for "government intervention"*
>
> (Brudney, 1985. p. 1403).

His argument is not in isolation as Roe (1991) also found that the initial separation of ownership and control in the US, at least in the 1930s, was because of legal and political factors; and not as an automatic response to the development of their firms. Criticizing agency theory also, Van Essen (2011) looks at the role of ownership in different contexts by taking into account the different formal and informal institutional constellations found in those contexts. He found that who owns the firms matter for the firms' strategies, objectives, and performance; i.e., a crucial factor with respect to the ownership concentration, firm strategy and performance relationships, is owner identity. While Van Essen (2011) has been investigating ownership from institutional perspective, his focus is on the role of ownership and not about how the ownership structure is shaped.

In relation to studies of board of directors also, although agency theory has been dominating corporate governance literature, it is however, claimed to provide very little information regarding actual board functioning and behaviour (Petrovic, 2008) and hence a call for greater theoretical pluralism and more detailed attention to board processes and dynamics (Roberts et al., 2005). They suggest that it is the actual conduct of the directors that determine board effectiveness; while board structure, composition, and independence only condition it. Turley and Zaman (2007) found that the most significant effects of the audit committee on governance occur outside the formal structure and processes. This is consistent with earlier observation that corporate governance is social process, hence, should also be investigated from social perspective.

Aguilera et al. (2008) challenged agency perspective and termed it as "closed system." They propose an organizational sociology approach to comparative corporate governance to better capture the patterned variation that results from interdependencies between firms and their environment. Their "open system" perspective view corporate governance in terms of effectiveness in achieving their goals. They adopt a much broader definition of effectiveness as opposed to agency theory and their proposed framework is comprehensive for assessing how institutional context affects the appropriateness of alternative governance process.

The adoption of codes of corporate governance developed in the Anglo-Saxon system by emerging economies have also been questioned by many as they argued that there exist institutional differences in these markets which should not be ignored in making corporate governance policies. Emerging markets normally have weak market for corporate control or different capital market structure (Singh et al., 2005) as well as relatively weaker institutions including corporate governance institutions (Gugler et al., 2003). Different institutions create different governance issues; and these differences affect the implementation of corporate governance recommendations (for example, Gibson, 2003). Hence, using policies designed for developed economies may prove ineffective or even counter-productive in emerging economies (Young et al., 2008). The utilization of agency theory is also questioned.

The codes of best practices found in the Anglo-American system are developed based on agency theory which means that the codes are developed based on the premise that the main corporate governance problem is self-interested management and weak, dispersed shareholders. This empirical context is in fact highly unrepresentative when taken outside the US and the UK since most firms in the world have a dominant owner. In fact, high concentrated ownership is a feature of publicly listed companies in emerging economies (Fan and Wong, 2005); where family or state holds a dominant stake (Berglof and Thadden, 1999; Claessens et al., 1999). The organizational activities in emerging economies can differ considerably from those found in developed economies (Wright et al., 2005) and corporate governance problems in this economies may require different solutions from those generated from agency theory perspective (e.g., Lubatkin et al., 2005). High concentrated ownership means firms could also face principal-principal conflict, i.e., conflicts between majority shareholders who dominate the board, and minority shareholders (Young et al., 2008). It also induces agency problems when tight control

allows controlling shareholders' self-dealings to go unchallenged internally by boards of directors or externally by takeover markets (Fan and Wong, 2005).

The implications of these institutional differences are many; for example, the cost of capital in these markets is higher due to their relatively weak institutions (Young et al., 2008). Fan and Wong (2005) argues that in emerging markets, the agency conflicts between controlling owners and the minority shareholders are difficult to mitigate through conventional corporate control mechanisms including board of directors. Hence, in these economies the Big 5 auditors plays a corporate governance role as evidenced by the fact that Big 5 auditors do take into consideration their clients' agency problems when making audit fee and audit report decisions as well as the evidence that firms hiring Big 5 auditors receive smaller share price discounts associated with the agency conflicts. Millar et al. (2005) posit that the relationship-based corporate governance of Asia's emerging market is characterized by government's orientation towards providing subsidized credit to firms in targeted industrial sectors and implicitly sharing the risk which acted against institutional transparency. The allegedly weaker corporate governance institutions in emerging economies relative to advanced countries also explain the differences in the sources of finance for investment across countries and differences in the returns on investment (Gugler et al., 2003).

Hoskisson et al. (2000) observe that despite being the most applicable paradigm for explaining firm's behaviour in emerging economies, the number of theoretical and empirical studies utilizing an institutional perspective in such context is limited. Such need for the focus on institutions is because emerging economies are still heavily regulated which means there are institutional influences. For example, the state-owned-enterprises are affected by government institutions, and at the same time, other private firms would also be influenced by institutional environment such as cultural and political.

From institutional perspective, corporate governance is a secondary institution influenced by much larger institutional and social forces. Understanding those forces would help in understanding corporate governance not as a mechanism dealing with agency issues but also seeing corporate governance as a political as well as social instrument.

5. CONCLUDING REMARKS

This paper argues that corporate governance research in emerging economies is dominated by agency theory perspective. While agency theory is important in explaining corporate governance in these economies, this paper argues that it is not sufficient. Alternative perspectives are needed in explaining the practice of corporate governance in emerging economies more holistically as emerging economies have different institutional context and non-economic factors as compared to more advanced economies. In doing so, this paper reviews corporate governance literature, focusing on those studies conducted in emerging economies, with the purpose to provide a detailed commentary on the nature of existing research on corporate governance in these economies and identify gaps in this literature. This paper proceeds by explaining on why agency theory is not sufficient and suggests for future work.

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