CORPORATE GOVERNANCE AND POLITICAL OWNERSHIP

1. INTRODUCTION

Corporate governance has become an important topic of debate in recent years. The 1997 financial turmoil in some emerging markets and developing countries have put corporate governance to the forefront. Although there are many reasons for the crisis, many economic journalists and commentators have attributed "crony capitalism" as one of the major causes of the crisis. Political patronage is believed to have undermined the standard of corporate governance. This paper will try to look into issues of how politics can influence corporate governance in the private sector.

Corporate governance often evolves in response to and seldom in spite of a crisis. The first documented governance failure was the "South Sea Bubble" in 1720-21. While the most recent case, is the East Asian financial crisis. The tightening of the rules and regulations by the KLSE in 1998 and the drafting of the Malaysian Code of Corporate Governance in 1999 are examples of the improvement in corporate governance after the crisis. Throughout history, changes only occur after a crisis and people have already suffered the consequences. The problems are not apparent or often ignored when the economy is booming.

Before the crisis East Asia was enjoying a long period of growth which has even received support from the World Bank in the Bank's (1993) 'East Asian Miracle' report. The long period of growth has apparently misled many people including policy makers into ignoring the importance of corporate governance. However, following the crisis, corporate governance became a major factor which international investors consider when investing in emerging markets. Portfolio investment flows and bank lending is known to have dropped precipitously since the financial crisis in East Asia. The year 1997 was a bad year for Asia in general with portfolio equity funds pulling out of most markets with the exception of China (Table 1). The hardest hit region seems to be South East Asia, which posted net outflow for countries like Malaysia and Thailand. However foreign direct investments (FDI) have managed to stay fairly constant (Table 2).

Table 1. Portfolio Investment Flows for Selected Countries
Equity
US$millions

	1970	1980	1990	1991	1992	1993	1994	1995	1996	1997	1998
Transition Economies											
China	..	0	0	653	1194	3818	3915	2807	3466	8457	1273
Hungary	..	0	150	0	34	13	340	483	1004	1810	259
Poland	..	..	0	0	0	400	5	921	722	945	969
Russian Fed.	..	..	0	0	0	0	271	141	5008	1206	296
Developing Economies											
Argentina	0	0	13	420	392	5529	1205	211	864	2236	50
Brazil	0	0	0	803	1734	5500	5082	4411	3981	3835	542
Chile	0	0	320	0	323	405	867	274	103	486	87
Colombia	0	0	0	0	0	169	320	131	290	116	26
Egypt,Arab Rep.	0	0	0	0	0	0	10	2	1233	1813	494
India	0	0	105	0	241	1840	4729	1517	4398	2116	342
Indonesia	0	0	312	0	119	2452	3672	4873	3099	298	250
Korea,Rep.	0	0	518	345	3045	6029	2525	3559	3700	1257	4096
Malaysia	0	0	293	0	385	3700	1320	2299	4353	-489	592
Mexico	0	0	563	4404	5365	14297	4521	520	3922	2052	730
Morocco	0	0	0	0	0	0	63	150	222	243	174
Pakistan	0	0	0	23	139	185	1335	729	700	252	0
Peru	0	0	0	0	0	1226	977	1611	2740	692	174
Phillipines	0	0	0	0	333	1445	1407	1961	1333	73	454
Singapore	..	..	..	..	..	..	..	..	..	..	..
South Africa	..	..	..	..	..	..	219	4571	1759	1393	619
Thailand	0	0	449	41	4	3117	-538	2154	1551	-308	2341
Turkey	0	0	35	0	0	534	1059	630	799	577	880
Venezuela	0	0	0	100	146	59	42	461	1740	429	64
Vietnam	..	..	0	10	0	87	283	155	390	-94	0

.. - Data not available

0 - Zero or less than half the unit shown

Sources: 2000 World Development Indicators, Global Development Finance 1999, World Bank; International Financial Statistics Yearbook 1999, International Monetary Fund.

Table 2. Foreign Direct Investment for Selected Countries
US$ millions

	1970	1980	1990	1991	1992	1993	1994	1995	1996	1997	1998
Advanced Economies											
Australia	..	..	7465	4365	5184	4031	4578	12802	5159	8612	6165
Canada	..	..	7581	2874	4777	4749	8224	9319	9408	11466	16514
France	..	..	13183	15150	21840	20750	15800	23730	21970	23040	27998
Germany	..	..	2532	4110	2640	1950	1940	11990	5510	10170	18712
Japan	..	..	1777	1290	2760	120	910	40	200	3200	3268
U.K.	..	..	32518	16260	16190	15590	9210	20320	28780	37010	67481
U.S.	..	..	48954	22010	17940	48990	44590	57650	77620	93450	193373
Transition Economies											
China	..	0	3487	4366	11156	27515	33787	35849	40180	44236	43751
Hungary	..	0	0	1462	1479	2350	1144	4519	1982	2079	1936
Poland	..	..	89	291	678	1715	1875	3659	4498	4908	6365
Russian Fed.	..	..	0	0	0	0	637	2017	2479	6241	2764
Developing Economies											
Argentina	11	678	1836	2439	4012	3261	3107	4783	5090	6645	6150
Brazil	421	1911	989	1103	2061	1292	3072	4859	11200	19652	31913
Chile	-79	213	590	822	937	1034	2583	2978	4724	5417	4638
Colombia	43	157	500	457	729	959	1667	2317	3276	5982	3038
Egypt,Arab Rep.	0	548	734	253	459	493	1256	598	636	891	1076
India	46	79	162	74	277	550	973	2144	2426	3351	2635
Indonesia	83	180	1093	1482	1777	2004	2109	4348	6194	4677	-356
Korea,Rep.	66	6	788	1180	727	588	809	1776	2325	2844	5415
Malaysia	94	934	2333	3998	5183	5006	4342	4132	5078	5106	5000
Mexico	323	2156	2634	4762	4393	4389	10972	9526	9185	12477	10238
Morocco	20	89	165	317	422	491	551	290	311	1200	322
Pakistan	23	63	244	257	335	346	419	719	918	713	500
Peru	-70	27	41	-7	136	670	3084	2000	3226	2030	1930
Phillipines	-25	-106	530	544	228	1238	1591	1478	1517	1222	1713
Singapore	..	..	5575	4887	2204	4686	8550	7206	7883	9710	7218
South Africa	..	..	..	..	..	..	334	993	758	1725	550
Thailand	43	190	2444	2014	2113	1804	1366	2068	2336	3745	6941
Turkey	58	18	684	810	844	636	608	885	722	805	940
Venezuela	-23	55	451	1916	629	372	813	985	2183	5087	4435
Vietnam	..	..	16	229	385	523	742	1400	1500	1800	1200

.. - Data not available
0 - Zero or less than half the unit shown

Sources: 2000 World Development Indicators, Global Development Finance 1999, World Bank; International Financial Statistics Yearbook 1999, International Monetary Fund.

Keen competition among developing countries to attract these investors may have forced these countries concerned to look seriously into the corporate governance issue. Due to keen competition, many developing countries are offering the same benefits such as tax subsidies, low cost and proper infrastructure. These benefits are no longer enough as globalization and the improvement in information technology meant that investors are getting better informed and will eventually set higher expectations. Therefore corporate governance can be used as a leveraging tool to attract investments.

It is a well-known fact that the Asian development approach includes a major role for political participation (Todaro, 1997). State intervention is a key factor in the growth of East Asia. However the quality of state intervention is questionable (Jomo, 1998). State intervention has produced many leading state owned corporations such as Pohang Steel Corporation in Korea and Malaysian International Shipping Corporation in Malaysia. State intervention can be indirect through the implementation of development policies and also direct through the ownership of shares in corporations.

This direct intervention involves political ownership. Political ownership can arise from a direct ownership by the state; ownership by politicians individually or through the holding companies of their respective political parties. There are two major reasons for the close links between the state and the corporations. Either the corporations are formally state enterprises that were subsequently privatized or these corporations managed to capture rents in the form of privatized projects created by the state.

Before the 1997 crisis, privatisation and liberalisation was an important part of economic policy for many countries. Recent data showed that privatisation proceeds peaked in 1997 when global amount raised from privatisation reached US$157.4 billion (Table 3). Privatisation changes a firm's ownership structure from public to private ownership. This change automatically opens the firm to market scrutiny and monitoring. Before privatisation, state owned firms are only liable to the state. However privatisation in most cases does not mean that state influence is totally removed from the firm.

Table 3. Breakdown of global amount raised from privatisation for selected countries[1]
US$ million

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999p
Australia	19	1042	1893	2057	2055	8089	9052	16815	7145	15048
Czech Rep.[2]	..	..	..	..	1077	1205	994	442	469	781
France				12160	5479	4136	5099	8189	12951	9509
Germany[3]		325		435	240		13228	1125	364	6734
Hungary	38	470	720	1842	1017	3813	1157	1966	353	88
Japan				15919	13773		6379	4009	6641	14856
Korea				817	2435	480	1866	539	600	2705
Mexico	3124	10757	6864	2531	766	170	73	2670	987	291
Poland	23	171	373	433	725	1101	1442	2043	2079	3422
UK[4]	12906	21825	604	8523	1341	6691	7610	4544		
US								3650	3100	
Total OECD	24824	37599	16757	55134	47838	53048	70081	100300	85886	100765
of which EU15	15662	24090	4247	29574	24939	32829	44557	67661	58484	61522
Other countries	8516	11605	17458	17983	18436	14551	22026	57155	45153	44000
Global total	33340	49204	34215	73117	66274	67599	92107	157455	131039	144765

.. Not available
- Nil or insignificant
p. Provisional

1. The amounts shown are gross proceeds from direct privatisation. These do not necessarily correspond to the net amount available to the government. The figures are on a calendar year basis and they may not add up to published budget figures.
2. The cumulative amount for the period 1991-93 is US$2240million.
3. Up to 1997, information on trade sales is not available.
4. Debt sales for years 1990-97 (fiscal years) amounting to £5347million, £7924million, £8189million, £5453million, £6429million, £2439million, £4500million respectively.

Source: Financial Market Trends, OECD 2000.

In many countries privatisation involves divesting stakes in state owned enterprises to private investors. However in most cases the government will remain as a controlling shareholder through a majority stake or a 'golden share'. Therefore in this scenario political ownership is not reduced. On top of that when projects are privatised it is very likely that the winning bidder has some political links. This would further increase political ownership.

Privatization was undertaken with the objective of improving the efficiency of state-owned enterprises. A consequence of privatization is the enhanced role of government regulators who exert efficiency constraints and performance incentives upon enterprises, which often enjoy dominant market positions.

In partially privatised corporations, the government plays a dual role as owner and regulator. There is a danger that this close links between the state and the privatised firms could create a situation where it could affect the standard of corporate governance. It would be difficult for the state to strike a balance between its role as owner and regulator if the objectives of the politicians in control are different. Politicians acting on behalf of the state as shareholders may not have the same priorities as a private shareholder. Politicians do not own any cashflow rights personally as compared to the private shareholder. The cashflow rights belong to the state. Therefore there is a possibility of an agency problem here.

1.1 Objective of the study

The study will try to examine the role of the State in corporate governance for selected countries. In particular, the focus will be on the implications of state ownership in privatized firms and their effect on corporate governance in these firms. This study focuses on privatized state owned enterprises because of their size in the economy as well as the size of political ownership. The largest listed companies in most countries in terms of capital are formerly state owned enterprises. For example Tenaga Nasional Berhad, Telekom Malaysia Berhad, Petronas Gas Berhad and Malaysian International Shipping Corporation collectively makes up about 22% of the total market capital in the Kuala Lumpur Stock Exchange. In the United Kingdom, BP Amoco represents about 8% while British Telecom about 6% of the total value in the FTSE 100 index.

1.2 Research Methodology

Although political ownership consists of anything from state ownership to ownership by politicians, political parties as well as state controlled trust agencies, this study will focus mainly on state ownership. In order to show the relationship between corporate governance and state ownership, attempts will be made to identify the factors and events that have determined the organisational structure of these companies, regulations and state policies. Some of the major listed state controlled companies will be selected for a detailed study. Existing models of corporate governance and rent seeking will motivate data collection and analysis. Data will also be collected from secondary sources such as annual reports of companies, published data by the statistical department and other related government agencies. Media sources will be consulted.

1.3 Organization of the study

The study will consist of six parts. Chapter 1 introduces the research paper. It will give an outline of the study, which will include the objective of the study, its significance, the methodology used and the organisation of the study. Chapter 2 surveys the literature on the concepts and definition of corporate governance and political ownership. The chapter is divided into two parts. The first part gives a brief review of the existing theories of privatisation focussing on the private property argument and the dispersed knowledge argument. Also included is a brief look at what the existing empirical evidence suggest. The second part reviews the existing literature on corporate governance. It outlines the different perspectives on the issues related to corporate governance such as authority, ownership structure, exit, voice, stakeholders and governance mechanisms. Chapter 3 briefly surveys the general trend in privatisation and its relation to political ownership. It will look at examples of privatisation in various countries including the UK, transition economies and developing economies and their experiences. This chapter also attempts to evaluate the extent of state ownership after privatisation has been carried out. Chapter 4 will discuss issues of corporate governance and its relationship with political ownership. It will briefly discuss the coıporate governance system adopted by different countries. It will also study the corporate governance issues in selected state controlled companies. Chapter 5 will seek to examine the relationship between corporate governance, political ownership and performance. Attempts will be made to evaluate if partial privatisation is good or bad for corporate governance. It will look into the possibility of corporate governance mechanisms being shaped by politics and agency problems arising from the state's dual role as shareholder and regulator. Chapter 6 concludes.