Family Networks, Corporate Governance and Economic Performance in East Asia

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Until the onset of the Asian financial turmoil that began in 1997, East Asia's corporate governance structure with its emphasis on family values was frequently, although not always, regarded as superior to their Anglo-Saxon counterparts. This view was popular with most media reporters and even in some academic circles. The West was at that time mired in an economic recession and was attracted to the performance of the East Asian economies, whose high rates of economic and productivity growth contrasted sharply with the stagnancy found in many industrialized economies of the West. The view found a ready audience not only among those in the West that were disheartened by the poor performances of their own economies, but also among Asian leaders eager to glorify their own policies and practices.

This view has now been reversed in the wake of the financial turmoil. Asian corporate governance is now perceived as a source of corruption and cronyism that is somewhat responsible for the current crisis. In particular the prominent role of the family network, once viewed as the strength of Asian corporate governance is now seen as a obstructing the proper separation of public and private domains in corporate concerns with very negative consequences. Overemphasizing the role played by corporate governance as the cause for the rise and the demise of the Asian economies runs the risk of ignoring many other factors that have played an important part in their growth, including the role of the family network. For this reason it is useful to draw sharp distinctions between three separate but related questions. First, why did the East Asian economy grow so rapidly? Second, what role did the structure of corporate governance play in this rapid growth? Third, did the family as an institution played an important role in facilitating economic growth? The answers to these questions provide a useful context for assessing how the structure of corporate governance in Asia needs to be reformed to support future economic prosperity.

East Asian Economic Performance

Real per capita incomes in the Asian economies have been rising at an average rate of 4-6 percent per annum since the 1960s. This rate is not some national-income accounting anomaly. Its validity is evident in the high and rising rates of consumption that all who have lived in or traveled through the region witness. It is also reflected in the vast improvements in health, life expectancy, and education of the region's people. Even if the present crisis were to cause all economic growth in the area to cease completely for the next five years, these economies would have performed well above the world average for some three decades.

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The Asians' success has been built not on the discovery of a new form of capitalism, but on a tried-and-true formula, the vital ingredients of which include a hard-working, well-educated, and trained labor force, and a vigorous entrepreneurial class that invests in plants and equipment. Each country in the region spends more on human capital than do the vast majority of nations with comparable levels of per capita income. Most of these nations also encourage entrepreneurial activities and appreciate the importance of the market economy. They have promoted economic freedom through lowering taxes and by reducing barriers and restrictions in markets for goods and services and in labor and capital. Moreover, the physical infrastructure, like highways, office towers, and factories, that these countries built at a breakneck pace are still in place. None of these vital ingredients have been fundamentally altered as a consequence of the Asian crisis.

Family Network and Economic Performance in East Asia

The proposition that the family network is conducive to economic growth and business profitability in Asia has considerable empirical support. Elsewhere, I present arguments and evidence in support of the validity of this proposition for small and medium-sized family businesses.[2] Many Asian values, especially those held among ethnic Chinese, can be traced to Confucian ideas or ideology, which emphasize family, collective or corporate responsibility within organizations, building consensus, and mutual commitment. These have been identified as distinctive Asian attributes and are believed to contribute to efficient economic performance.

Since most businesses in Asia are predominantly small and medium-sized family-owned firms, the importance of the family to Asia's economies is obvious. As a consequence, the family as an institution played a very important role in facilitating economic growth through helping small and medium-sized businesses resolve principal-agent problems and by reducing moral-hazard questions arising from information asymmetries in pre-modern or emerging credit and capital markets. The family as an institution filled in some of the gaps that remained in a partially developed market system.

Nevertheless, these observations are less applicable to the issues discussed in the corporate-governance literature, which focuses on the principal-agent problem arising from the separation of ownership from control that is present in large publicly listed firms operating in formal mature capital and credit markets in developed industrialized economies. The problem becomes relevant as the financial system in these economies begins to develop over time, and many small and medium-sized family-owned firms grow and go public. Until this takes place, the structure of corporate governance in these small and medium-sized firms is simply not an important issue for aggregate economic performance.

The implication is that the importance of small and medium-sized businesses in many developing East Asian economies suggests that the family as an institution promotes growth in economies with pre-modern financial systems. Another implication is that the structure of the corporate governance of firms is not directly relevant until these economies and firms begin to grow and the pre-modern financial system is modernized. This transition took place

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[2] Y. C. R. Wong, "Entrepreneurship, Marriage and Earnings", *Review of Economics and Statistics*, Vol. 68, No. 4, November 1986, pp. 693-699.

at different times for each individual Asian economy, depending on its stage of development. The transition occurred first in Japan in the 1980s, as capital markets were gradually liberalized. The economic stagnancy that followed the bursting of the asset bubble in the 1990s has in large part been caused by the failure of Japan's traditional corporate governance structure. The turmoil in South Korea in the current financial crisis is certainly a consequence of that country's severely repressed credit markets. In some of the economies in Southeast Asia the story is similar, even though the details and the contexts may vary.

Corporate Governance and Economic Performance in Asia

One important feature of the alleged superiority of the East Asian economies prior to the downturn was its corporate governance structure, which was characterized by the concentration of share ownership. The concentration of corporate share ownership in East Asia takes two forms. First, a single family often owns the majority of the outstanding stock and dominates the board of management—a form common throughout Southeast Asia. Second, senior management dominates the board of management, and the corporation is a member of a "family" of firms connected by a shared history, complementary operations, interlocking shareholdings, and a privileged banking relationship; a form common in Japan, but less prevalent in Southeast Asia.

The concentration of ownership was thought to enable East Asian corporations to avoid the "short-termism," redundancies, and high executive remuneration that many believed corporations in the West were suffering from, with negative consequences for efficiency and profitability. The single-family-dominated corporation was believed to be immune from such shortcomings, because the principal-agent problem could be resolved through the concentration of share ownership. Since family members were believed to share the same interest in enhancing the value of the corporation, therefore, the significance or relevance of the principal-agent problem was minimized.

The Japanese corporate governance structure was similar. It was believed that the interests of the principal and the agent were internalized through a process of socialization that took place both within the corporation and in society at large. Since the socialization process would also consume corporate and social resources, it was not clear a priori that the value of the firm and of the economy as a whole would be enhanced as a consequence. Nevertheless, the works of scholars like Chalmers Johnson and Ezra Vogel strongly presumed that Japanese firms and Japan Inc. were highly competitive, and that, therefore, by implication, the Japanese corporate governance structure was deemed instrumental to Japan's impressive economic performance.

These views spawned a literature emphasizing the cultural attributes of these East Asian societies as underpinning their economic successes. The dubious and incomplete nature of the reasoning behind such views made them highly suspicious from the very beginning.[3] The supposed superiority of the East Asian corporate governance structure have now been seriously discredited amidst allegations of corruption, cronyism, lack of transparency, and indecisiveness.

[3] It is interesting to note that in the 1960s the prevailing wisdom of Western social science knowledge viewed Confucian ideology as an obstacle to economic development.

Public perception of the alleged superiority of the Asian corporate governance system have shifted rapidly following a decade of Japanese economic stagnancy, the appearance of the Asian financial and economic turmoil, and the sustained, decade-long growth of the U.S. economy. This paradigm shift is now in danger of swinging to the other extreme: the assumption that the so-called Asian miracle had no substance, that it was built on a house of cards, which inevitably collapsed under the weight of cronyism and corruption. These conclusions are no more valid than the ones they seek to refute.

To overemphasize the corporate governance issue as the cause for the rise and the demise of the Asian economies is to ignore many other factors, identified at the outset, that has played a part in their growth. It is nevertheless true that the structure of corporate governance in Asia needs reforming in the wake of the recent financial and economic turmoil. It is also true that the structure of corporate governance will have an important influence on the long-run prospects of Asian economic growth and on the structure of political economy in these societies.

What is Corporate Governance About?

Corporate governance is not about the relationship of corporations to society. Nor is it about the regulation of corporations in the interest of society: regulation backed by the force of law is the domain of civil government and political economy, not of corporate governance. Equally important, corporate governance is not about fostering economic growth through the development of business operations that can allow companies and economies to compete successfully. Corporate governance is neither the study of economic competitiveness and development strategy nor the promotion of enterprise and growth. Conversely, corporate governance is not just about administrative rules that are imposed on corporations independent of shareholders' wishes or corporate circumstances.

Properly understood, corporate governance refers simply to ways of ensuring that a corporation's agents, actions, and assets pursue the definitive corporate ends set by the corporation's shareholders. If the activity of the corporation is business, then the pursuit of profit or of enhancing the market value of the corporation should be its sole purpose. The managers of the corporation, as agents of the shareholders, are expected and obliged to pursue this sole objective of the corporation.

It is of course entirely acceptable to establish corporations for purposes that do not involve business. Non-government organizations are good examples of such types of corporations. Without elucidation I take it as obvious that the corporate objectives of NGOs are less precise than those of business corporations. As a consequence, the principal-agent problem is often more serious among NGOs than business corporations. The problem is further compounded by the fact that many NGOs receive contributions from donors who have very weak incentives for monitoring the activities of these recipients, especially the contributions from government. Public officials seldom rebuke NGOs for failing to meet the conditionalities tied to public contributions, and the taxpayer is even less motivated.

Although this definition of corporate governance excludes many interesting concerns, it provides a framework for the rigorous exploration of questions that are central to the proper functioning and control of corporations.

What Needs to be Reformed, and Why?

An important issue is that of how corporate governance should be reformed in Asia. At the heart of the Asian financial and economic turmoil is the weakness of the financial system in many Asian economies. A weak banking system and an over-dependence on that banking system for funds are key features contributing to an unhealthy financial system. Banks in the future will have to improve their ability to perform credit risk-assessment functions and reduce their reliance on collateral-based lending. Commercial banks must become independent; they must be free from political tampering and should not become tools for achieving government policy objectives, in order to perform proper assessment of credit risks when making commercially based lending decisions. Finally, allowing for effective competition in the financial system that would enable firms to raise funds via sources other than banks would be a positive step. To achieve this would entail a prudent opening of the financial system. For these developments to occur, it is necessary to put in place a regulatory framework and supervisory machinery that would (1) enhance the flow of information from borrowing companies to lending institutions, and (2) encourage institutions to make prudent, commercially based decisions via market competition. These changes have obvious implications for the reform of corporate governance structures. More importantly they would mean reforming existing power structures that protect or preserve vested interests that are apprehensive about the consequence of greater competition.

For corporate governance to be improved in such a world, it must provide greater assurance that corporate actions, assets, and agents are directed at achieving the corporate purposes established by the corporations' shareholders. Because shareholders and their purposes are diverse, however, both the types of accountability those shareholders want, and the favored methods of securing them, can vary significantly. The best way to reflect divergent preferences, and to discover optimum methods of fulfilling common preferences, is to make the objectives of corporate governance clear, and to subject the mechanisms for achieving them to free competition in the marketplace.

What we want is a market for corporate control. Included under this concept are not merely takeovers to transfer corporate ownership, but also the creation of a market in which companies compete for shareholders and investment managers compete for funds, in part on the degree and kinds of accountability they afford to owners. The challenge is to find ways to open up such competition and to extend competition that already exists in respect to operational performance to the corporate governance mechanisms that affect it.

Advocating a market for corporate control does not mean that corporate governance should be the sole or even the preferred criterion for assessing investments. Corporate governance is only a means; the end is always the achievement of the substantive corporate objective. For business, that end is maximizing shareholder value, which depends on business strategy as much as on corporate governance. In evaluating corporate governance, the focus should therefore not be on procedural "hygiene" matters that limit corporate flexibility.

It would be rather unfortunate if the reform of corporate governance systems should lead us to a diversion of our attention away from the corporation's founding objectives. East Asian corporations already suffer from the fact that the objectives of stakeholders in the company other than shareowners often have a major influence on business decisions. Many

large corporations are, for example, coerced by the state and other powerful groups to make political contributions and social transfers. These demands have a price. These corporations are rewarded with special privileges for being a "good citizen". All too often in the East Asian context the phrase "corporate social responsibility" becomes a euphemism for various types of corruption, cronyism and rent seeking activities.

The core assumptions of the popular stakeholder theory is incompatible with enhancing the ability of a corporation to achieve its substantive objectives by reducing the flexibility of business corporations in pursuing their goal of maximizing shareholder value. By heeding the demands of diverse stakeholders, business corporations will be compelled to pursue ill-defined objectives and management performance will become more difficult to evaluate. This would not be in the interest of shareholders that are the ultimate owners of the corporation. The stakeholder theory of corporate governance therefore undermines both private property and accountability. As such it is incapable of providing a better system of corporate governance.

Similarly, enlarging the regulatory role of the state in an attempt to improve corporate governance by limiting shareholders' options and reducing their freedom to control their own companies as they choose is necessarily counterproductive. The indications to strengthen regulation in the wake of financial turmoil are no panacea and should be put in proper perspective. The aim of regulation is to provide a better framework for corporations to become accountable to their shareholders, not to society at large. The latter is a hopeless task for it leaves undefined who represents the interests of society at large. Moreover by weakening the property rights of shareholders over their own shares it opens the door for the dissipation of rent in valuable assets.

The way to strengthen corporate governance mechanisms in East Asia is to improve the accountability to their ultimate owners, preferably by having corporations compete for investments and funds. To achieve this, reforming the financial system is necessary and complementary to reforming the structure of corporate governance.

It is interesting to note that the strength of the small and medium-sized Asian family-owned firm lies to a large measure in its ability to raise funds through informal family-based networks. It is also a reflection of the inability of the formal financial system to meet the needs of such firms. In a sense, a considerable part of the Asian economic miracle was financed through informal credit networks outside the formal financial system. These informal networks are also relatively free from the control of the state, whose policy actions have often hindered the development of the formal financial system. As a modern market based financial system develops, the crucial role of family based networks in raising capital will become less important to business corporations in these economies. This may in the longer run pave the way for the emergence of professional managers that are not recruited from among relatives.

While immediate economic recovery in East Asia will not depend on reforming the financial system and revamping the structure of corporate governance, however, it will certainly pave the way for future long-term economic growth. Indeed, a modern, market-oriented corporate governance structure based on maximizing shareholder value will be increasingly critical to the sustained future development of the East Asian economies in a globalized world economic system where international capital is free to flow anywhere.