Chapter 7
Equilibrium in Corporate Governance:
Effects in Developing Countries

Sonia Marcos
University of Burgos, Spain

Luis A. Castrillo
University of Burgos, Spain

ABSTRACT

Corporate governance systems around the world are shaped by legal traditions, but the most important determinant of their effectiveness is law enforcement. Developing countries tend to have weak institutional structures and contracting environments. In this context, markets are inefficient and ownership concentration becomes the main corporate governance mechanism in order to protect property rights. How can developing countries design an optimal corporate governance system in their poor business environments? Corporate governance mechanisms are interdependent, and each country needs to search for a set of mechanisms in equilibrium—that is, an optimal combination of control and incentives—that solves its own agency problems. But another problem in developing countries is the lack of public enforcement. Just as internal mechanisms may substitute for ineffective external mechanisms, private initiatives may reinforce weak public enforcement.

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INTRODUCTION

Firms' stakeholders can choose among different internal corporate governance mechanisms that aim to control agency problems. This choice is conditioned by the availability and efficiency of external corporate governance mechanisms, which in turn depend on the institutional framework in which the firm operates. Legal and political systems and stakeholders' pressure are the starting point of corporate governance design in each country. Each country's legislation determines the protection of investors in their relations with firms, thus influencing the predominant external control by markets. This relationship between legislation and market control also gives rise to various conflicts and agency problems, specific to each institutional environment, which have to be resolved through different combinations and arrangements of corporate governance mechanisms (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997, 1998, 2000). Each firm shapes its own corporate governance structure according to external controls and incentives, leading to an equilibrium.

This chapter provides a theoretical framework to elucidate the complexity of corporate governance taken as a whole and explain how corporate governance models are built. The institutional framework, corporate governance mechanisms, and performance are not independent variables. Rather, they interact to generate an equilibrium solution, which is the corporate governance model shared by most of the firms in the same country. Developing countries have very heterogeneous institutional frameworks, and each environment provides a starting point for corporate governance to thrive. A lack of external control from markets and government could be compensated by strong insider mechanisms, such as concentrated ownership or family control. Developing countries' weak capital markets, poor investor protection, and lack of board independence elicit an insider approach to corporate governance that compensates for these weaknesses (Agyemang, Kyeraa, Ansong, & Frimpong, 2017; Humayun & Adelepo, 2012; Isukul & Chizea, 2016). The result expected will be an equilibrium corporate governance structure.

The main goal of this chapter is to present a dynamic corporate governance model in balance that shows how, in developing countries, the relationship between internal corporate governance and firm performance is conditioned by legal and colonial origins, investor protection and confidence, capital market development and efficiency, among other factors.

This chapter is organized as follows. First, it explains agency conflicts and corporate governance through agency theory. The next section explains how institutional frameworks and law enforcement determine corporate governance models around the world. The two next sections discuss how corporate governance is in developing countries and how corporate governance mechanisms interact as either alternatives or complements. The chapter also explains the equilibrium phenomenon, and its

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