Formal and Informal Institutions in Asia
A Survey of Asian Corporate Governance

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Abstract
Comparative literature in corporate governance typically separate between countries with different legal origin, institutions and corporate traditions. However, the importance of informal institutions and their effects on the economic development, firm performance and corporate governance should not be neglected. Informal institutions have been claimed to be of extra importance foremost Asia. This paper comprise of a general discussion on legal origin and formal and informal institutions. This discussion is then connected to recent studies on corporate governance issues in Asia. The results are mixed, but a general picture of corporate governance in Asia is presented. Foremost formal institutions and legislations seems to have their intended effect on the economy in general. However, differences between the countries become clear and the influence of informal institutions seems to differ substantially between the Asian countries. The impact of formal institutions in contrast to informal institutions is important since the economical effects for many of the developing countries in the region may be imperative.

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Introduction

The interest in institutional settings and its effects on countries’ economies has been revitalized substantially during the last couple of decades. Williamson (2000) indeed stress this point and further argues that the new institutional economics still pose several unanswered questions. We will come back to Williamson shortly. However, an explanation of the term new institutional economics is necessary and also natural due to the old institutional economics, or basically the German Historical School which was active in the late 19th century with scholars such as Roscher and von Schmoller. Relying solely on real world observations and case studies, the German Historical School disregarded abstract economical theories and universal axioms to a full extent. Yet, notions of what today is considered business cycles were introduced in the German Historical School based on these observations. Also, the ideas that detailed cultural contexts would be the main explanation behind economic development and differences between countries was very influential. While the German Historical School meets positive reactions in Europe, it did not enjoy much attention in North America at the time.

The influence in Europe from the German Historical School decreased substantially during the first part of the 20th century and instead the neoclassical school and theorization of economics became increasingly dominant. Yet, in 1986 R. C. O. Matthews, quite sensationaly, claimed that ‘the economics of institutions has become one of the liveliest areas in our discipline’. Later Matthews (1986) defended his claim and declared that ‘institutions do matter’ and ‘the determinants of institutions are susceptible to analysis by the tools of economic theory’ (p. 903). Ever since Matthews’ statements in 1986, the growth and influence of the new institutional economics literature and research has rapidly gained momentum. The ever changing nature of institutions and their actual influence on economic development pose interesting challenges to researchers. Furthermore, the different types of institutions tend to change at different rates of speed.

North (1990) separates institutions into ‘informal constraints and formal rules and of their enforcement characteristics’ (p. 384). While the formal rules and their enforcement characteristics are partially possible to quantify and measure, informal constraints, or informal institutions, pose a much larger problem in that sense for researchers. Furthermore, the relative importance of the formal and informal institutions seems to differ around the world. Roche (2005) for example stress the importance of informal networks and family traditions in corporate governance in Asia. On the other hand, the formalized rules and legal origin has also been shown to have a strong effect on corporate governance in Western countries, especially Anglo American countries (see La Porta et al. (2008) for an overview of the studies of legal origin and its importance made during the last decade). During the last decade, influences of the formalized Western institutions have become much more central and implemented in many Asian countries. One of the most prominent reasons for this is doubtless the economical crisis in Asia in 1997. Countries like South Korea, Indonesia and Thailand, which were most severely affected by the crisis, had to undergo substantial changes in legal systems, corporate governance systems and structural reforms to receive support and help from the IMF (see also OECD White Paper (2003)).
These circumstances make the institutional structures, the formal and informal, very interesting to study. The events taking place before, during and after the economical crisis of 1997 in Asia have been studied on both country level and between countries. The purpose of this paper is to synthesis these studies and their results for a comprehensive overview of the institutions of Asia.

The structure of institutions
Returning to Williamson (2000) and the structure of institutions, he adds one more dimension, or level, to the structure\(^1\); a continuous process for use of and interpretation of institutional settings. This structure of the economics of the institutions leaves us with four levels of the institutional setting and also institutional change over time. The structure of the economics of institutions as it presented by Williamson (2000) is illustrated in Figure 1. While Williamson does not explicitly use the world cultural context as the German Historical School did in his structure of the economics of the institutions, the top level includes informal institutions, customs, traditions, norms and religion.

*Figure 1, Economics of Institutions structure*

<table>
<thead>
<tr>
<th>Level</th>
<th>Frequency (years)</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>Embeddedness: informal institutions, customs, traditions, norms, religion</td>
<td>100 to 1000</td>
<td>spontaneous</td>
</tr>
<tr>
<td>Institutional environment: formal rules of the game–esp. property (polity, judiciary, bureaucracy)</td>
<td>10 to 100</td>
<td>Get the institutional environment right. 1(^{st}) order economizing</td>
</tr>
<tr>
<td>Governance: play of the game–esp. contract (aligning governance structures with transactions)</td>
<td>1 to 10</td>
<td>Get the governance structures right. 2(^{nd}) order economizing</td>
</tr>
<tr>
<td>Resource allocation and employment (prices and quantities; incentive alignment)</td>
<td>Continuous</td>
<td>Get the marginal conditions right. 3(^{rd}) order economizing</td>
</tr>
</tbody>
</table>

\(^1\) The original framework discussed here was presented first in Williamson (1998), Figure 1 was however presented in Williamson (2000)
Figure 1 shows each of the four levels of the economics of institutions in Williamson’s structure of institutions. Level one, is made up by social theory. Here we find informal institutions, customs, traditions, norms and religion. All these aspects clearly have some parallels to the old institutional economics (the German Historical School) and its main focus on cultural context as an explanation for economic development and differences between countries. However, Williamson in his structure of institutions show that changes on this level occur over very long time periods, from centuries up to millennia. The change is partially caused by influences from the level below, the institutional environment, or “the formal rules of the game”. The influence between each level of the institutional structure is however much stronger downwards than upwards. So, even though we observe some similarities between the old and new institutional economics, new institutional economics have a much more complex picture of institutions, how they change and at what speed. Furthermore, and clearly most important, new institutional economics does not dismiss all economic theory and axioms as the German Historical School did. Rather, economic theory founds the basis for new institutional economics.

The third level in the economics of institutions presented by Williamson is the how the formal rules in level two is interpreted and followed by legislators. Again, the influences on level three on level two is stronger than the influence upwards in the structure. The fourth level, as already mentioned, illustrates the everyday process of adapting to and allocates resources efficiently depending on the current institutional state and its interpretation. Again, the linkage and importance from the level above is much stronger than the effects upwards. There is a given hierarchy of how the different parts of the institutional structure affect each other down the structure. However, according to Williamson (2000) there is also this feedback process affecting the structure upwards.

Based on this structure, it is clear that the most influential factor is the informal institutions. Never the less, these are very hard to study and quantify, and they also change very slowly. Williamson calls this section social theory. The formal institutions and how they are interpreted and implemented is addressed the economics of property rights and transaction cost economist respectively. Neoclassical economics or agency theory represents the continuous, fourth level in the institutional structure.

Thanks to Williamson’s structure of institutional economics it is possible to organize a comprehensive literature overview in the same manners on research made of each of the four levels. Focusing on the institutional structures of Asia, the remainder of the paper is structured in the following way: next section holds a general discussion on corporate governance and agency theory in general and its links to institutional framework in a country. Thereafter, a summary of recent research on institutions and the effects on corporate governance in Asia is presented in the aspect of ownership structures, board compositions and dual vote systems and pyramidal ownership. The paper concludes with a discussion on the previous findings and what questions that may still need some attention.
Legal origin, ownership protection and informal institutions in Asia

In studying institutions and their effects on economical growth, firm performance and ownership of firms one need to address the early works of Berle and Means (1932). Even though we have seen a massive increase during the last decades in the literature on ownership and performance of listed firms around the world, much of this work builds on Berle and Means pioneering article from 1932. The article deals with agency cost and dispersed ownership using the US and the Anglo Saxon legal origin as an example. However, it was written after (or during) the period when a large share of the firms in the US changed from being held in business groups to being single firms with dispersed ownership. The transition was rapid and thorough mainly due to changes in double dividend taxation, the public utilities holding company act, investment company act and securities and exchange commission act (Morck and Yeung (2009)). The discussion on ownership referring to Berle and Means naturally focus on a dispersed ownership of publicly held firms for this reason. The relationship between shareholders and managers under both dispersed and concentrated ownership is later treated theoretically by Jensen and Meckling (1976). They show how the issues of separation of ownership and control and concentrated ownership affect the agency costs and manager’s decisions for the firm. In firms where the supervision of managers, either by controlling owners or legal protection of shareholders, is low, managerial discretion is commonly a problem. Williamson (1963) discuss how managers may enrich themselves rather than the shareholders both in monetary and non pecuniary terms. Much of this discussion is originally based on the situation described by Berle and Means with dispersed ownership and a strong legal protection of shareholders.

The United Kingdom does show similarities with the US in the ownership structure of firms. The explanation behind this is however rather different from the one described for the US. In United Kingdom, family ownership and control of firms was fairly common and had even increased in the first half of the 20th century. By using dual class shares, families could maintain control of the firms with a disproportional relation between voting power and capital. This was possible even at a time when hostile takeovers and acquisitions increased and the pressure from institutional owners were common. However, with new regulations and changes on the London Stock Exchange, dual class shares were prohibited. Family controlled firms where rapidly being taken over and ownership became dispersed in the United Kingdom (Frank et al. (2004)).

As mentioned, the general view is that the Anglo Saxon legal traditions offers a generally strong legal protection of minority shareholders (see for example La Porta et al. (1997), Morck et al. (1987) and Holderness and Sheehan (1988)). This increased protection of minority shareholders decrease the risk for minority shareholders to be expropriated by managers and/or controlling shareholders. Supporting this, dispersed ownership has been shown to be fairly uncommon for a majority of countries with other legal origin than the Anglo Saxon, or common law tradition. Somewhat surprisingly, Shleifer and Vishny (1986) show that ownership even in the US may be concentrated, yet moderately so compared to other countries.
A multitude of both case studies and cross country studies has shown that concentrated ownership is indeed prevalent around the world and, furthermore, that the controlling owner often is defined as an individual or family (see for example Denis and McConnell (2003), La Porta et al (1999) and Shleifer and Vishny (1997)) just as case with the United Kingdom during the first half of the 20th century.

The consequence is that the original discussion on dispersed ownership and control is based on a fairly uncommon example. Yet, the effects on corporate governance systems, ownership structures and institutional settings for countries with different legal traditions have been thoroughly investigated, however, with some diverse results. The division made by La Porta et al. (1998) suggests in line with earlier studies that the common law, or Anglo Saxon legal tradition offers a better protection of minority shareholders than the civil law legal traditions. The authors divide the civil law legal traditions into Scandinavian, German and French legal traditions. Scandinavian legal traditions offer the highest minority protection and French the lowest. In practice the Scandinavian legal tradition use elements from both the civil and common law traditions. Further supporting the division between different legal origins, La Porta et al. (1999) show in a cross country study that countries with higher degrees of protection of minority shareholders (common law) have a higher degree of dispersed ownership compared to countries with lower minority share holder protection (civil law). The results are also supported by Faccio et al (2001) who study the relationship between dividend payouts and the legal protection of minority shareholders. They find that there is a strong correlation between the level of legal protection and the level of dividend payouts to shareholders.

The strong relationship between legal protection of minority shareholders, the relative concentration of ownership and dividend payouts has however been questioned. Mueller (2006) show that the average dividend payout indeed is higher in countries with an Anglo Saxon legal tradition than the average payout in countries with civil law. However, he also shows that the average dividend payout is higher in countries with French legal origin than the German. Furthermore, Mueller (2006) stress the fact that there are large differences within groups of countries with similar legal traditions with high diversity for civil law countries. For example, the Scandinavian legal traditions seems o offer better protection of minority shareholders than the German and French, much in line with the suggestion that this legal tradition is a mixture of common and civil law. Also, firms in countries with Asian-Germanic and the European-Germanic legal traditions differ substantially in dividend payouts according to Mueller (2006), illustrating the differences within the German legal traditions.

This is not the only case of disparity from the division of legal traditions made by La Porta et al. (1998). In fact, the response has been massive in terms of articles supporting or rejecting the importance and effects of legal origin. For example, Fagernas et al. (2008) show by compiling 60 different indicators of shareholder protection that Germany offers a higher level of protection than the US. Furthermore, they also show that the level of shareholder protection change over time. Some ten years after publishing their article, La Porta et al. (2008) address the issues and consequences of legal origin again, now in the light of research
done after their previous series of papers. Just as Williamson, La Porta et al. (2008) illustrate the connection between institutions and effects on society with a figure. However, the figure is horizontal in its effects rather than vertical as in Willianms’ case. Also, the driving force behind institutions is the legal origin of a country. This illustration of legal origin, institutions and outcomes is reproduced in figure 2.

**Figure 2, Legal Origin, Institutions, and Outcomes**

![Legal Origin, Institutions, and Outcomes Diagram]

Source: reproduction from La Porta et al. (2008)

If we compare this figure with the one representing the institutional structure presented by Williamson, legal origin may be considered similar to the second level of Williamson’s structure. The institutional column in Figure 2 compares to the third level in Figure 3 and the Outcomes may very well match the continuous resource allocation level suggested by Williamson. In addition to these similarities, Figure 2 also presents some more detailed information concerning what institutions actually may be. Even more importantly, the outcomes suggested are something that may very well be measured and used for evaluation of the effects from certain institutional settings. The background for all of the institutional settings, the legal origin should still be discussed.

La Porta et al. (2008) note that the division between the common law (Anglo Saxon law) and civil law (French, German and Scandinavian law) holds differences within the groups for natural reasons. For example, the common law legal traditions and its influence around the
world is much the result of colonizing and the fact the countries may have been forced to adapt to its legal system. Other states have voluntarily chosen their legal systems in phases of modernizing of their countries, such as the Ottoman Empire and Russia during the 19th century adopting the French civil law. Whether the country was forced to adopt the legal system or chose it voluntarily may have had effects on the development of the legal system in that country over time. The Scandinavian legal origin is concentrated to one region, much due to the fact that colonizing was spares, or non-existing. Even though the kinship to German legal traditions is strong, Scandinavian legal traditions are generally considered to be different enough to be distinguished as a separate legal tradition.

Over time, the legal systems of the countries have been influenced by international law, other legal systems, culture and political background. Yet, La Porta et al. (2008) claim that the general division of legal traditions still holds. Countries in each of the groups are more similar in their legal traditions still, than across the groups. According to La Porta et al. (2008) legal origin is not a proxy for culture, politics and history which has been raised as criticism against the studies claiming the importance and impact of legal origin. Instead, legal origin should be considered a variable with enough explanatory power to explain differences in economic growth for countries.

The importance of legal traditions for corporate governance, firm performance and economical growth in a country cannot be denied. However, it is clear that both differences and similarities between countries should be explained with additional factors than the legal traditions only. Asian countries are often given as an example of the complexity between formal and informal institutions and the effects on the corporate governance system. So far, the informal institutions has been mentioned by Williamson and given an important role affecting the whole institutional structure. However, the informal institutions are not implemented in the figure by La Porta et al. The effects from informal institutions on the formal institutional structure may very well be much more direct in Asian than Western countries, complicating the study of the impact of legal origin primarily on corporate governance, firm performance and economic growth in Asia (Roche, 2005).

When looking closer at the Asian countries we observe that there are many cases of high levels of concentrated ownership, control enhancement tools and the controlling owners are often individuals or families. These complexities have resulted in that corporate governance in Asia has received quite substantial attention during the past decades. Claessens and Fan (2002) provide us with a thorough overview of research on corporate governance in Asia up to 2002. According to the Claessens and Fan (2002), Asia poses as an interesting example also due to the Asian financial crisis in the late 1990’s and the subsequent effects on the corporate governance systems. Compared to earlier studies the conclusion, that even though the protection of minority shareholders in Asia is overall low firms are not always badly run or exploited by controlling owners or board members, is rather remarkable. This contrasts to earlier literature (see for example Jensen and Meckling (1976) Fama (1980)) which suggests that low protection of minority shareholders will in turn make the management focus on
enriching themselves or some other goal not increasing, or even safeguarding, the returns to
the investors.

There are several other reasons why Asia pose as such an interesting example; the relation
between management and minority shareholders, and their protection may not only depend
on legal settings but also on trust and informal contracts between the agent and principals.
Relatively large impact of informal institutions and the importance of family affiliations all
affect the formal institutions and the legal. Furthermore, informal networks between firms
from different types of industries are especially important in some countries in Asia. The so-
called guanxi relationships and personal honor influence contacts between owners and
management, contracts between firms and how the firm is run to a high degree (Hamilton,
1992). It is important to recognize these similarities and differences in the corporate
governance system in the most influential economies in Asia and supply reasoning about both
the traditional formal institutions and the informal institutions in the region.

**Principal agent theory**

Before presenting an in depth review of the studies made on Asia it is necessary to give brief
discussion on principal agent theory and its development. Since the discussion of the
interaction between investors and management was brought to attention by Berle and Means
(1932) agency theory has been developed as describing the different incentives and goals for
investors and management of the firm (See for example Eklund (2008) for a comprehensive
background on the importance of Berle and Means’ *The Modern Corporation and Private
Property*). Jensen and Meckling (1976) discuss agency cost and the problem for investors to
monitor the managers, and raises certain questions about the influence from minority
shareholders versus both controlling shareholders and the management of a firm. While the
fundamental purpose for the management of a firm is to maximize the value of the firm to its
investors, there are some self-interest issues in agency theory concerning the relation between
shareholders and management. The investors’ objective for the firm is to receive a positive
return on their investment, while the managers of the firm may have other objectives for the
firm such as improving the growth of the firm, its reputation, or even more privately
objectives such as the security of their own employment or simply financially reward
themselves in any way. Since managers hold both the information about the firm and the
decision making power while the investors, especially the minority shareholders, mainly hold
the financial risk of the firm the incentives for the shareholders to control the managers is
high.

The investors face several problems when trying to control the management. While some
activities are easier to observe and control, for example salaries, other activities including
non-pecuniary payments are harder for the investors to gain information about. According to
Williamson (1963) non-pecuniary payments introduced to the theory of the firm will cause
some analytical problems. Yet, non-pecuniary payments exist and may take many different
forms. For example expansion of the number of employees will likely offer positive rewards
to the management due to increased possibilities of promotion compared to the fixed-size
firm. It may not only increase salary due to promotions, but also improve other attributes
such as increased security, power, status, prestige and professional achievement. The problem with non-pecuniary payments compared to salaries is that the receiver has more restrictions on how it is spent. On the other hand, due to tax reasons non-pecuniary payments may be more attractive as well as being less visible rewards to the management, making it less provocative to shareholders.

The agency problems between investor and manager has been offered some possible solutions such as monitoring of actions by independent boards and giving economic incentives such as stock options to managers. However, the possible influence investor may have on management clearly increase as the investors controlling abilities increase. Whether it is by large direct ownership of the firm or enhancing functions such as pyramidal structures or vote differential shares, a controlling shareholder has much more impact on the management than the minority shareholder. Hence, problems arise not only between management and investors but also between minority and controlling shareholders. The importance of contracts between investors and the firm and the enforceability of rule of law becomes imperative for the minority shareholders to be able to protect their own interests.

In addition to the mentioned agency problems between the investors, management and the controlling owners is that control enhancing tools such as pyramids, cross-holdings and the use of vote differential shares often can be traced to single families controlling the firm (see for example La Porta et al. (1999), Morck et al. (2004) or Faccio and Lang (2002)). As controlling families are often appointing management positions to individuals who are in some way related to the family, either in blood or through informal networks, potential agency problems face the possibility to be enhanced.

**Corporate governance in Asia**

The agency problems in Asia, with high deviation between control and cash flow rights, are generally known and anticipated by investors and hence also reflected in relatively lower share prices. Yet, low transparency, the informal networks and the influence by an often protective government still poses important agency problems and uncertainty in many Asian economies. The lower price of shares does to some extent reflect the increased uncertainty of the investment (Roche, 2005).

When describing corporate governance in Asia Roche (2005) presses the issue of the heterogeneity of the region, both within countries and between them. The possible consequences and importance of historical factors forming the corporate governance should not be underestimated when studying the Asian countries, a statement that should be compared with that of La Porta et al. (2008). Roche does not ignore the influence form legal traditions, but he does recognize that other factors may have a much higher impact in Asia compared to other parts of the world. Corporate governance in the Anglo Saxon countries and in Asian have very different starting points in terms of cultural differences, timing of events, political processes and international affiliations. The informal institutions forming the formal institutions in Williamson’s structure of institutions look rather different at the top level when comparing Asia and Europe for example.
Many of the Asian countries embrace very different legal and economic diversity, for example the legacy of European colonialism is very strong in countries like Hong Kong, India, Malaysia and Singapore with their Anglo-Saxon origin legal system. Yet, European colonialism has also affected the legal systems in Thailand and the Philippines with French origin legal systems. China, Taiwan, South Korea and Japan with German legal traditions have been influenced by other reasons, Japan for example adopted the German legal system as a step in the country’s movement from a feudal agriculture country to an industrialized nation (R. Morck & Nakamura, 2004). In the case of Taiwan, its legal system originally relied much on that of China which just like Japan looked to the German legal systems during its period of modernization ((R. La Porta et al., 2008).

Furthermore, as pointed out by Roche (2005) there is also an array of culturally, linguistically and religiously differences in a region with more than two billion people. In many Asian countries it is common that the legislation is implemented in advance of the corporate practice. In some cases, adoption to new legislations may be very slow, for example the implementation of double board structures in China and its effects on firm performance and general recommendations for corporate practice (Dahya et al. (2003).

According to some (for example Roche (2005) and Solomon et al. (2002)), it may actually be the case that the introduction of legislations by the state rather than a reliance on self-regulation in fact accelerate the convergence and achievement of best practice. Formal international institutions such as the European Union and the OECD may introduce preemptive legislations for increasing convergence toward a best practice. However, in Asia the Association of South East Asian Nations (ASEAN) has historically not been working actively to implement and support cross country legislations. In recent years this has changed however, as the ASEAN countries are working on improving their dialog on corporate governance in the region (ASEAN, 2009).

The impact of legal origin is however notable also in the Asian countries. When we compare the legal origin as grouped by Muller (2006) with information about accounting standards, creditors rights and contract enforceability provided by Gugler et al. (2003) we get a good overview of the complex effects there may be on the corporate governance systems depending on legal traditions (Table 1).
Table 1 Legal origin and corporate governance indicators in Asia

<table>
<thead>
<tr>
<th>Country</th>
<th>Legal Origin</th>
<th>Accounting Standards</th>
<th>Creditor Rights</th>
<th>Contract Enforceability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>English Origin</td>
<td>69</td>
<td>4</td>
<td>n.a.</td>
</tr>
<tr>
<td>India</td>
<td>English Origin</td>
<td>57</td>
<td>4</td>
<td>1.94</td>
</tr>
<tr>
<td>Malaysia</td>
<td>English Origin</td>
<td>76</td>
<td>4</td>
<td>2.28</td>
</tr>
<tr>
<td>Singapore</td>
<td>English Origin</td>
<td>78</td>
<td>4</td>
<td>3.17</td>
</tr>
<tr>
<td>Thailand</td>
<td>English Origin</td>
<td>64</td>
<td>3</td>
<td>2.23</td>
</tr>
<tr>
<td>Japan</td>
<td>Asian-Germanic Origin</td>
<td>65</td>
<td>2</td>
<td>3.12</td>
</tr>
<tr>
<td>South Korea</td>
<td>Asian-Germanic Origin</td>
<td>62</td>
<td>3</td>
<td>2.20</td>
</tr>
<tr>
<td>Taiwan</td>
<td>Asian-Germanic Origin</td>
<td>65</td>
<td>2</td>
<td>2.53</td>
</tr>
<tr>
<td>Indonesia</td>
<td>French Origin</td>
<td>n.a.</td>
<td>4</td>
<td>1.73</td>
</tr>
<tr>
<td>The Philippines</td>
<td>French Origin</td>
<td>65</td>
<td>0</td>
<td>1.81</td>
</tr>
<tr>
<td>China</td>
<td>German / Socialist*</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
</tbody>
</table>


While the creditor rights index is higher in the common law origin countries (denoted English Origin by Mueller) than the countries with other legal traditions, indicators such as accounting standards and contract enforceability does not show the same consistency. This supports for example the arguments by Roche (2005) and Mueller (2006) that several other factors than legal origin has important effects on the country’s corporate governance system and the development of the system. Depending on what informal institutions really constitute it is likely that historical background, informal networks and law enforcement in reality does affect the formal institutions in some informal way.

The awareness of the importance of corporate governance has increased massively in Asia during the last couple of decades according to Roche (2005). The concept of corporate governance was more or less unknown in China some decades ago. But due to the economic development and also some serious financial and market manipulations scandals the concept of corporate governance has received an increased amount of attention for improvement and regulations. This is not unique for China; most of the Asian countries have gone through improvements in the corporate governance system.
In many cases, the Asian financial crisis in 1997 caused governments and firms to evaluate their corporate governance system and seek improvements. The economical effects on firms and countries due to the crisis could to some extent be traced to the current state of the corporate governance system (Roche, 2005). Countries with more well-developed and well-defined systems tended to be less affected by the crisis. To dampen the effects from possible new economical downturns, countries with relatively less developed corporate governance systems were given incentives to develop their systems. The IMF for example induced countries like South Korea to drastically change their corporate governance rules if they would be eligible for economic support from the IMF.

Table 2 illustrates the effects on currency and stock markets for a handful of the Asian countries during the economical crisis in 1997. The effects from the crisis struck some of the countries especially hard and much of the debate concerned the factors behind the crisis.

**Table 2 Effects from the Asian financial crisis in 1997-1998***

<table>
<thead>
<tr>
<th></th>
<th>Currency change, %</th>
<th>Stock Index change, %</th>
<th>Market Fall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>-83.2</td>
<td>-35.0</td>
<td>-$96bn (-88%)</td>
</tr>
<tr>
<td>Thailand</td>
<td>-40.2</td>
<td>-48.0</td>
<td>-$40bn (-66%)</td>
</tr>
<tr>
<td>Malaysia</td>
<td>-39.4</td>
<td>-56.0</td>
<td>-$217bn (-76%)</td>
</tr>
<tr>
<td>The Philippines</td>
<td>-36.1</td>
<td>-33.8</td>
<td>-$43bn (-58%)</td>
</tr>
<tr>
<td>South Korea</td>
<td>-34.1</td>
<td>-58.7</td>
<td>-$111bn (-71%)</td>
</tr>
<tr>
<td>Singapore</td>
<td>-16.5</td>
<td>-43.5</td>
<td>-$91bn (-53%)</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>n.a.</td>
<td>-43.2</td>
<td>-$223bn (-42%)</td>
</tr>
</tbody>
</table>


Source: Clarke (2000)

From table 2 it is clear that the financial crisis was truly severe. However, there is not any clear pattern between legal origin and the effects of the crisis. It seems that the effects on the common law countries (Thailand, Malaysia, Singapore and Hong Kong) are just as big as the civil law countries (Indonesia, The Philippines and South Korea) in the table. Letting legal origin explain economic growth and firm performance, it does not seem to affect country resistance to financial crises, at least not in this example.

The general trend since the financial crisis has been a movement towards western influenced corporate governance systems in most Asian countries. The degree of change has, however, varied greatly across the countries. According to Roche (2005), there have been improvements in most Asian countries and efforts have been made to improve the legal and
regulatory systems underpinning corporate governance. However, in other areas such as discipline, transparency and accountability the improvements have varied substantially between the Asian countries.

Roche (2005) singles out Singapore and Hong Kong as the countries with the class leaders in corporate governance. India is also represented as a country which has had its corporate governance system improved substantially. All three countries being old British colonies in Asia clearly has had some influence from legal origin and the legacy of a colonial power on their corporate governance. Countries like Taiwan, South Korea and Malaysia have improved as well, but not to the same extent as the previous countries. Taiwan, South Korea and Malaysia with German and English legal origin respectively have not been under colonial rule at the same extent as Singapore, Hong Kong and India. Thailand and the Philippines are still in need of improvements, and Indonesia seems to be lagging behind considerably. These countries also have a mixture of legal origin and also colonial influence. Possible linkages between legal origin, colonial influence and corporate governance do not seem to be totally clear for the region. Japan has always been and will probably remain a special case in many ways in Asia, something that is also true for their corporate governance system. The Japanese system has seen very little improvements and has very low transparency. Table 3 illustrates the improvements of self regulations imposed by firms in the Asian countries for improvement of the corporate governance system.

**Table 3 Implementation of self regulations 1997 / 2003**

<table>
<thead>
<tr>
<th></th>
<th>Official code of best practice?</th>
<th>Mandatory independent directors?</th>
<th>Mandatory audit committees?</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>Yes/Yes</td>
<td>Yes/Yes</td>
<td>No/Yes</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>No/Yes</td>
<td>No/Yes</td>
<td>No/No</td>
</tr>
<tr>
<td>India</td>
<td>No/Yes</td>
<td>No/Yes</td>
<td>No/Yes</td>
</tr>
<tr>
<td>Indonesia</td>
<td>No/Yes</td>
<td>No/Yes</td>
<td>No/Yes</td>
</tr>
<tr>
<td>Japan</td>
<td>No/Maybe</td>
<td>No/Optional</td>
<td>No/Optional</td>
</tr>
<tr>
<td>South Korea</td>
<td>No/Yes</td>
<td>No/Yes</td>
<td>No/Yes</td>
</tr>
<tr>
<td>Malaysia</td>
<td>No/Yes</td>
<td>Yes/Yes</td>
<td>Yes/Yes</td>
</tr>
<tr>
<td>The Philippines</td>
<td>No/Yes</td>
<td>No/Yes</td>
<td>No/Yes</td>
</tr>
<tr>
<td>Singapore</td>
<td>No/Yes</td>
<td>Yes/Yes</td>
<td>Yes/Yes</td>
</tr>
<tr>
<td>Taiwan</td>
<td>No/Yes</td>
<td>No/Yes</td>
<td>No/No</td>
</tr>
<tr>
<td>Thailand</td>
<td>No/Yes</td>
<td>No/Yes</td>
<td>No/Yes</td>
</tr>
</tbody>
</table>

Source: Asian Corporate Governance Association ACGA (2002)
Several studies of corporate governance and its development have been presented during the last decade. On self implemented practice by the firms Chuanrommanee and Swierczek (2007) considers the corporate governance statements by financial corporations in three ASEAN countries; Thailand, Malaysia and Singapore. The authors find that the corporations’ own description of their governance show a much more improved corporate governance structure than previously reported and in fact in line with international best practices. However, they suggest that the statements do not fully reflect the real practices carried out and that the corporate governance of the financial corporation’s does not live up to the international best practices. Information and openness is possibly affected by these differences.

Singh and Zammit (2006) considers the Asian “way of doing business” and a possible ongoing shift to an US way of doing business. As mentioned, the Asian financial crisis in 1997-1998 is by many claimed to have been caused by the Asian corporate governance system. However, the authors reject this hypothesis and instead claim that in general the Asian corporate governance model has been well-functioning and that the market competition is high, not low as suggested earlier. Furthermore, Singh and Zammit (2006) claims that the US business model would not benefit Asia as a whole since the area consists of industrialized countries and developing countries at different stages in their development. The US corporate governance has severe limitations for developing countries due to imperfect share prices and imperfect market for corporate control, according to the authors.

Solomon et al. (2002) studies the reforms of the South Korean corporate governance system after the Asian economic crisis in 1997-1998. The effects from the crisis hit South Korea especially hard since the large conglomerates where to large extent financed via debt and also a general low accountability for investors in the corporate governance system itself since the crisis. The reforming of the South Korean corporate governance system has been heavily inspired by western standards and is moving towards globally harmonized corporate governance. It is mainly investor relations, the accountability of Chaebols and an increased encouragement of shareholder initiatives that should strengthen the South Korean corporate governance system.

Lee and Yeh (2004) study the relationship between ownership, corporate governance and sensitivity for economic distress in Taiwan. By using proxies for corporate governance systems such as level of controlling owners and board positions, the loan ratio for shareholders and the dispersion of ownership and cash-flow rights, they test the economic sensitivity from corporate governance factors. Lee and Yeh (2004) finds that firms with weak corporate governance are more vulnerable to economic distress and also that the risk that the firm will fall into financial problems increase with a weaker corporate governance system.

Kao et al. (2004) find indications of a negative relationship between collateralized shares and firm performance in Taiwan. Further, they show that the negative relationship exists only for conglomerates. Kao et al. (2004) suggest that these findings point towards a larger principal-agent problem in conglomerates than regular, non-conglomerate firms. The principal-agent
problems may be limited by increasing the monitoring by institutional investors and creditors. Furthermore, dividend policy may affect the principal-agent problem positively and have positive effect on the firm performance according to the authors.

According to Buchanan (2007) the Japanese corporate governance and ownership structure is foremost characterized by “internalism”. The general idea about the management of Japanese firms is that the directors should be internally appointed or recruited and integrated into the firm. The “internalism” is based on informal institutions affected by specific historical and economical circumstances with stronger foundations than the modern view on corporate governance and the appointing of the management. These informal institutions may be affected by external elements according to Buchanan (2007) but are not likely to do so in a near future.

Corporate governance and the adoption of new business models originating from outside Japan is discussed by Seki (2005). While changes in corporate governance has received an increased attention in Japan by both scholars and practitioners the results has, according to the author, been marginal. However, prominent changes in the composition of shareholders and changes in the legislation will lead to greater awareness of the effects from a changing corporate governance system. Seki (2005) predicts an increased shareholder activity in Japan in the future.

Arikawa and Miyajima (2005) study the influence on raising of firm capital by the level of interaction between banks and firms in Japan. By examining between 969 and 1,341 firms each year from 1986 to 2000 they find strong links between bank relationship and composition of debt. It seems that successful firms with strong ties to banks are more prone to issue public bonds than borrow from banks.

Liew (2007) studies the development of the corporate governance system in Malaysia after the financial crisis in 1997-1998. It gives clear indications of the problems of implementing an Anglo Saxon corporate governance tradition into a traditionally more socially focused governance model. Personal networks, typical for the Asian firms, remain important for the managers, contrary to the Anglo Saxon corporate governance system which focus mainly on the shareholders’ accountability on management. Pik Kun (2007) states that the reforms towards a Anglo Saxon inspired corporate governance system has in fact not been achieved and may hurt the Malaysian economy in face of future economical crises.

The Chinese corporate governance system has been studied by Zhang (2007) who finds some disturbing elements in the legal protection of shareholders. The Chinese movement to a market oriented creation of a corporate governance system lacks a basic legal foundation according to Zhang (2007) since disciplining measures are not implemented. Misbehaving managers are not punished in the legal system and the possible risk of punishment by legal system does not work as a repellant.
With a case study Dahya et al. (2003) gives an interesting illustration of corporate governance in China. The adoption of a two tier board structure, one board of directors and one supervisory board, and two separate annual reports by all Chinese listed firms show how the market reacts to irregularities in the general corporate governance system. The case study show that a firm not reporting the supervisory board report (either by mistake of negligence) suffers from more distrust from investors and a lower market value. The authors suggest that the Chinese corporate governance need to safeguard the supervisory board report and strengthen its function.

Ownership structures in Asia and consequences
Ownership structures of Asian firms has been studied extensively during the last couple of decades, they show a concentrated ownership with commonly family, or state, ownership as the predominantly type of owner. La Porta et al. (1999) summaries the ownership of the 20 largest firms in terms of market capitalization of common equity for 27 countries. Of the 27 countries however only Hong Kong, Japan, Singapore and South Korea represent Asia in the dataset. Using a cutoff of 20 percent of the voting rights to determine control, 90 percent of the large\(^2\) traded firms in Hong Kong has concentrated ownership. The corresponding figures for Japan, Singapore and South Korea are 10, 85 and 45 percent. Using a lower cutoff for controlling ownership at 10 percent, the amount of concentrated ownership remain at 90 percent for firms in Hong Kong, but increase to 40, 95 and 60 percent for Japan, Singapore and South Korea respectively. The share of firms with one controlling owner stand in sharp contrast to the dispersed ownership observed in for example the US.

La Porta et al. (1999) also consider the type of ownership defining a family ownership as whether the controlling shareholder is an individual or not. State ownership is treated in a similar way with controlling shareholders being defined as government ownership. Using the 20 percent cutoff for determining ownership control, Hong Kong has relatively high level of family ownership at 70 percent of the firms with concentrated ownership. Japan, Singapore and South Korea have only 5, 30 and 20 percent family ownership of the firms with ultimate owners respectively. The figures are fairly stable for the lower cutoff at 10 percent of the voting rights for all four countries. With the exception of Singapore with about 45 percent state ownership, state ownership is low at around 5 to 15 percent. This is rather surprising for South Korea since the influence of the often family controlled Chaebols is considered to big large.

Claessens et al. (2000) use a further developed version of the methodology from by La Porta et al (1999) and use a dataset with 2,980 firms in nine East Asian countries (Hong Kong, Indonesia, Japan, South Korea, Malaysia, The Philippines, Singapore, Taiwan and Thailand). Finding, and addressing, both a high level of control enhancing mechanisms such as dual voting shares and family ownership (according to the authors more than half of the East Asian firms are family controlled) make the paper interesting from a comparative perspective

\(^2\) La Porta et. al. (1999) also study medium-sized firms and find that the medium-sized firms show a higher level of concentrated ownership in all the Asian countries. Family ownership is also more common in the medium sized firms than in the large firms for all the Asian countries.
for the Asian countries. Claessens et al. (2000) find that firms in Japan are most often widely held, while firms in Indonesia and Thailand in most cases have concentrated ownership often held by families. Furthermore, state control of firms is common in Indonesia, South Korea, Malaysia, Singapore and Thailand. It is also found that size and age of the firms affects ownership in East Asia. For example, the relatively small firm and/or older corporation are more commonly controlled by a family. As the level of economic development increase, the concentration of control generally decreases. Except from Japan, family ownership of firms is common in East Asia. In Indonesia, the Philippines and Thailand about half of the firms in the sample are controlled by ten families. In Hong Kong and South Korea about a third of the firms in the sample are controlled by families. Overall, Claessens et al. (2000) gives a picture of concentrated ownership, high family ownership and high levels of control enhancing mechanisms.

Joh (2003) study 5,829 South Korean firms and the effects from ownership concentration and investor interests prior to the Asian economical crisis in 1997. Joh find that firms with dispersed ownership typically show a lower profitability than firms with high ownership concentration. Firms with high separation between ownership and control i.e. via control enhancing mechanisms such as pyramid ownership show a lower profitability. Furthermore it is found that controlling shareholders expropriate firm resources even when their ownership concentration is relatively low.

Yeh et al. (2001) study the ownership structure of 208 publicly traded family firms in Taiwan. According to Yeh, family control and concentrated ownership is higher in Taiwan than many other Asian countries. They find signs of a non-linear relationship between the level of family control and the performance of the firms. In general, a family firm with low levels of control performs worse than firms with high levels of family control. They also find a negative relation between firm performance and the number of board members being part of the ownership family. These results point to positive effects for the firms from high family ownership but relatively low involvement in the management of the firm.

Sheu and Yang (2005) study the performance of 333 listed Taiwanese electronics firms using total factor productivity measurements and the effects of inside ownership. They find a non-linear relationship between the level of executive-to-insider ownership and performance of the firm. The highest and lowest level of executive-to-insider ownership has a positive effect on productivity. The board-to-insider ownership and the total insider ownership are not found to have any effects on the performance.

Wiwattanakantang (2001) studies a sample of 270 Thai firms. While concentrated ownership in the form of a controlling owner improves the performance of the firm (higher ROA and sales-asset ratio), Wiwattanakantang (2001) does not find evidence for expropriation of firm resources by controlling shareholders. One possible explanation is that control enhancing mechanisms are rarely used to separate control and cash-flow rights. Furthermore, this may explain the higher profitability for firms with high ownership concentration as controlling shareholders might be self-constrained not to expropriate extra benefits. However, a higher
involvement of the controlling owner in the management and board affects the firm’s profitability negatively. Last, it is shown that family firms, firms with foreign control and firms with more than one controlling shareholder (>25% of the voting rights) perform better than widely held firms.

Tam and Tan (2007) study ownership impact on performance in the largest 150 firms in Malaysia. Ownership is divided into individual (family), state, foreign and trust fund ownership where individual ownership constitute for 65% of the firms. They find that the type of ownership affect performance of the firm in different ways, foreign owned firms having the best performance, and then followed by family firms and state owned firms. The level of concentration of ownership is also found to have a negative effect on the performance of the firm and is explained by low levels of minority shareholder protection.

Family ownership of firms in Asia tends to affect the board composition for firms. If the family owners have some certain interest that does not match the interest of the shareholders, the effects on board composition and managements may be very important. The family ties and informal networks for the controlling owner may affect board composition in a way that is not in accordance with other shareholders.

**Board composition and transparency**

Fan and Wong (2002) focus on ownership structures and also the effects on transparency of management decisions in seven East Asian economies; Hong Kong, Indonesia, Malaysia, Singapore, South Korea, Taiwan and Thailand. Fan and Wong use the same data as Claessens et al. (2000) but exclude Japan resulting in a dataset with 1,740 firms. The reason for excluding Japan from the dataset is for Asian conditions unique ownership structure. Furthermore, firms with ultimate owners having less than 20 percent of the voting rights are excluded from the dataset. By studying the level of ownership and transparency of firm actions as well as reported earnings, they are able to find a negative connection between ownership concentration and informativeness of the management. They explain the relationship as an entrenchment of the controlling owners which both gives the ability and incentive to manipulate earnings and concealment of rent-seeking and proprietary information is done to eliminate potential competitors.

Chau and Gray (2002) study the relation between ownership structures and voluntary disclosure of firm information for 122 firms in Hong Kong and Singapore. They find that higher levels of outside ownership, defined as proportion of equity not belonging to directors or controlling shareholders, increase the level of voluntary information disclosure to the public. Firms with high level of insider ownership, defined as a strong connection between ownership and management, and family held firms tend to provide the public with less voluntary information. Since a large portion of the firms in Hong Kong and Singapore are closely held or owned by families the level of insight in firm activities are highly restricted according to Chau and Gray (2002).
Kim (2005) study the relation between board network characteristics and firm performance for 199 large, listed South Korean firms between 1990 and 1999. The board’s network is identified as both its density and its external social capital. Density is defined as the contact intensity between the board members and external social capital is defined as the board members degree of external contacts. The results show that a moderate level of board density enhances the firm performance, but as the density increase more it has a negative effect on performance. Also, board members having external social capital affects the firm performance positively according to Kim (2005).

Chiang and Lin (2007) find similar, non-linear, results for Taiwan using also using total factor productivity to measure the impact on firm performance for 232 listed firms by ownership structure and the composition of the board. They also find that conglomerates are more productive than non-conglomerates, that high-tech firms are more productive than low-tech firms and contrary to other studies that family firms are less productive than non-family firms.

In their study of Japanese firms, their board composition and ownership structure, Yoshikawa and Phan (2005) finds that the board structure affects the product diversification of the firm. In general, the number of corporate nominee directors in the board is correlated with lower levels of product diversification in the firm. Yoshikawa and Phan (2005) concludes that Japanese corporate nominee directors see themselves as representatives of certain production interests. Hence, the board composition should be taken into consideration by investors for assessing the level of protection of certain interests. However, in this case, there remains a potential possibility of a principal-principal problem rather than the classical principal-agent problem.

Ong et al. (2003) examines the factors affecting board interlocking for 295 listed firms in Singapore using ten independent variables such as firm size, financial contacts and firm performance. The authors find that for Singapore, an increase in interlocking of boards can mainly be explained by increased firm size, a higher firm performance, the size of the board and if the firm is a financial institution.

Wan and Ong (2005) test the relation between board structure, board process and performance of 212 listed firms in Singapore. They find that the structure of the board does not affect the process of the board, but that the board process affects the performance of the firm. Furthermore, the board process is negatively affected by decreased board transparency and conflicts within the board. These characteristics can be related to the individual board members. Yet, Wan and Ong (2005) could not find that board process works as a mediating role between board composition and performance.

Wen et al. (2002) study the relationship between board characteristics and the capital structure for 60 listed Chinese firms during 1996 to 1998. They find that the capital structure is effected by the structure of the board and the tenure of the CEO. However, they do not find any effects on the capital structure from the board size or the compensation to the CEO.
According to Wen et al. (2002) this suggests that the Chinese corporate governance system is not functioning as well, or in the manner, of western theoretical finance literature.

The composition of the board is important, not only for the specific firm but also firms and shareholders of firms that are owned by other firms. In firm with a board focusing on its own enrichment and which enjoys control over other firms with relatively small shares of capital, control enhancing tools such as dual vote shares become even more important.

**Control enhancement and pyramidal ownership**

Lim and Kim (2005) study the ownership structure of 30 major South Korean conglomerates (Chaebols) from a direct ownership perspective and also the indirect effects from the degree of family stake in the firms. They find that conglomerates with high levels of leverage and a large share of nonmanufacturing businesses usually have a direct ownership. Pyramidal ownership is more common in the large conglomerates and conglomerates with high degrees of nonvoting shares. Lim and Kim (2005) also find that South Korean conglomerates with a focused business line have a higher level of family stake, while conglomerates owning more listed firms and conglomerates using nonvoting shares have lower levels of family stake.

Yeh (2005) studies 251 Taiwanese firms to find a possible relationship between control enhancing mechanisms, negative entrenchment effects and firm valuation. He finds that corporate valuation is higher for firms with a controlling shareholder with higher degrees of cash-flow rights. A lower than median cash-flow right has a negative effect on the valuation of the firm. Negative entrenchment effects are avoided by positive incentives for controlling shareholders which increase the valuation of the firm when increasing cash-flow rights. For family firms, it is found that the valuation of the firm decrease as the controlling shareholder increase their influence over the firm with increased voting power through cross-holdings, deep and regular influence on the management and appointing of the board members.

Chen et al. (2007) implement and test an index for evaluation of corporate governance efficiency in 3,233 firm year observations in Taiwan. The index consists of four different aspects of the governance of the firm; the duality of the CEO: s, the size of the board of directors, the size of the management’s holdings and the size of the block shareholders’ holdings. The index is shows a strong link between corporate governance efficiency and the performance of the firms. Firms scoring high on the corporate governance efficiency index show higher performance than firms with low efficiency.

In general, control enhancing tools, dual voting shares and pyramidal ownership is very common in Asia. However, the control enhancement may look very different in the countries. In South Korea for example, the ownership structure with one firm on top is fairly common. In this case, one firm control many other firms through relatively small shares of capital. In Japan on the other hand, firms tend to be held through cross ownership. In this case there is a cross dependence between the firms.

**Conclusions**

The importance and influence of legal traditions on economic growth, firm performance and corporate governance cannot be underestimated. Furthermore, legal traditions seem to more
than just a proxy for historical and cultural influences. Yet, the formal institutions formed by the legal traditions are influenced by informal institutions to some extent. This influence tends to be of shifting importance in different parts of the world. The importance of informal institutions in Asia cannot be neglected, just as legal traditions cannot be underestimated. This pose as an interesting problem for research within the area.

A review of recent research done within the area enhances the picture of the complexity of the institutional structure in Asia. Each study presented show some important parts of how both the formal and informal institutions affect economic growth, firm performance and corporate governance in the region. It will however always be much harder to measure informal institutions and their effects on the economy than the formal institutions. This paper does however propose to the idea that the effects from informal institutions may be found by sometimes reading between the lines.

This paper aims at synthesizing studies of corporate governance in Asia foremost since the financial crisis in 1997 and connected it to a general discussion on corporate governance and legal traditions. It would however be interesting to take the literature overview one step further and make an empirical meta study of previous results for a general impression of the Asian corporate governance. Furthermore, an increased understanding of the linkages between informal and formal institutions would improve the possibilities to study the effects on economical development, firm performance and corporate governance.

References


