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The political economy of corporate governance in developing economies: The case of Bangladesh

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ABSTRACT

The paper investigates the influence of concentrated shareholding, boardroom politics and interest group politics in the quality of corporate governance in listed firms. It finds that the controlling shareholders exert influence in boardroom politics through family-aligned board and executive management. The evidence shows that concentrated ownership, family-aligned board and management, and political connection(s) of the controlling shareholder(s) tend to be inversely associated with the quality of corporate governance in a firm. The findings of the study suggest that the broad-based interest group politics which influence both political preference and corporate control politics contribute significantly to the current state of corporate governance in developing economies.

1. Introduction

The issue of corporate governance is widely acknowledged as a major challenge in achieving sustainable financial sector development and economic growth in developing economies (Nenova, 2004; Oman and Blume, 2005; Iskander and Chamlou, 2000). The significance of better corporate governance in private as well as public sector firms has also emerged as one of the most critical components

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of regulatory reform in these countries. This paper attempts to make a link between the controlling shareholder group, the rent-seeking politicians, bureaucrats and their relationship with the nature and timing of corporate governance reform. More specifically, it investigates how concentrated ownership, boardroom politics and broad-based interest group politics influence the quality of a firm's overall governance. To the best of our knowledge, existing literature does not appear to have addressed this critical issue. This paper also highlights the role of concentrated ownership in boardroom politics in listed companies.

This study aims to contribute to the theoretical development on political economy of corporate governance from the perspective of a developing economy such as Bangladesh. Bangladesh represents an interesting case for this study because the controlling shareholders or entrepreneurs tend to have a significant influence in the country's political process and corporate-control politics. This study is likely to have important policy implications for the development partners such as the World Bank, who sponsored Western version of corporate governance reform without really considering the interest-group politics involving powerful stakeholders of a developing economy. The study results suggest that concentrated shareholding, family-aligned board and management, and political connections of the controlling shareholders tend to be inversely associated with the quality of corporate governance of a firm.

Recent studies of the political economy of corporate governance have challenged the well established law-and-economics tradition based on the legal origin and the quality of corporate laws (QCL), and have put forward a political economy model to explain country-level variations in investors' protection. In response to the economic interests of the different stakeholders, the political process creates or changes laws, and thus acts as a link between legal rules and economic outcomes (Pagano and Volpin, 2005; Bebchuk and Neeman, 2005). This section of the paper is based on a review of the two recent political economy models of corporate governance, namely, the voting model and the interest group politics model. The former regards the voting process as the prime determinant of investor protection, whereas the latter puts forward the notion of power and the influence of powerful interest groups in shaping corporate laws of investor protection and transparency.

Pagano and Volpin (2005) propose a political economy model of corporate governance based on cross-country data on political determinants of investor and employment protection. The model assumes that the political process determines the motives as well as the timing of changes in corporate law by formalizing the behaviour of voters. The voting process plays a crucial role in aggregating the conflicting preferences of the voters or agents of the economy, e.g. maximizing private benefit for the entrepreneurs, providing strong investor protection for the minority shareholders, and offering protection against dismissal of workers. It is shown that the political preferences of the entrepreneurs and workers tend to influence the political parties in a proportional voting system (e.g. Continental European countries and Japan, where winning a majority of the votes is crucial) to design a policy agenda that produces weak shareholder protection and strong employment protection. On the contrary, the political outcomes of the Anglo-Saxon countries (whose political systems tend to be majoritarian, i.e. winning a majority of districts ensures victory) tend to produce strong shareholder protection and weak employment protection.

Other researchers also regard politics as a significant determinant of corporate governance, and favour the voting model, where a political majority determines the corporate governance as well as financial and labour regulations in a democratic society (Roe, 2003). It is worth noting that the convergence of interests between entrepreneurs (or managers) and employees can take place not only in the macro-political arena (Pagano and Volpin, 2005) but also at the level of the firm, where the management uses generous employment contracts (e.g. long-term employment contract, high wages, lax monitoring) to the benefit of employees, at the expense of non-controlling shareholders (Pagano and Volpin, 2005b).

Gourevitch (2003) extends Roe's (2003) version of the political economy model by analyzing alternative preferences of the interest groups with reference to class-based or left-versus-right divisions, and sector-based or cross-class coalitions. Bebchuk and Neeman (2005) propose a similar model to analyze how political interplay of the three different interest groups (e.g. corporate insiders, institutional shareholders, and entrepreneurs) affects the level of investor protection or private benefits of control. In this model, all three interest groups compete for influence over politicians, who gener-