CHAPTER - 2

CORPORATE GOVERNANCE AND ECONOMIC GROWTH IN NIGERIA: A THEORETICAL PERSPECTIVE

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INTRODUCTION

Corporate governance has become a topical issue in view of its importance for business, economic growth and development the world over. Corporate governance has links with economic performance. It is a well established fact that good governance impacts positively on growth. Growth is positively related to both the side of investment and the efficiency of the allocation of investment.

Good corporate governance translates to dedication to duty by directors and managers of enterprises and companies. Directors of enterprises carry out their duties within the framework of honesty, transparency, accountability and value for money within good corporate governance tradition.

The frequency of business failure at all levels in the last decade has motivated a lot of interest on corporate governance. The current global economic meltdown has also brought to the fore the need for good management of business institutions and administration of people to achieve socio-economic stability and sustainable development.

Despite their recent convergence, corporate governance (CG) systems worldwide remain diverse. In Anglo-Saxon countries, CG aims to maximise shareholder value while in many other countries, including Europe and Asia, it continues to target maximisation of stakeholder value, regardless of major reforms that strengthened shareholder value considerations. In Nigeria, shareholder value considerations seem a dominant objective. In the country, the concern for shareholder value informed the inclusion of Corporate Audit Committee in the Companies and Allied Matters Act 1990. For the same reason, Zonal Shareholder Associations were formed in Lagos, Kano, Onitsha, Jos, Ibadán, Port Harcourt and Kaduna under the aegis of the Bureau

for Public Enterprises (BPE), formerly called the Technical Committee on Privatisation and Commercialisation (TCPC).

The need for corporate governance has arisen out of the divorce in modern corporations between the rights of shareholders and other suppliers of capital on the one hand, and the operational control, which is in the hands of professional managers, on the other. This can be described as the "principal-agent" problem. Put simply, the question is: will the managers run the corporation exclusively for the long-term benefit of the shareholders and the economy? Also, what mechanisms can be put in place to ensure this takes place? To this end, the systems of corporate governance are designed to provide a framework for managing companies or corporations.

The "principal-agent" problem informed the promotion of the shareholder associations in Nigeria by the BPE in 1991, in its belief that the involvement of shareholders in corporate decision making would improve shareholder value. Moreover, under commercialisation of the BPE Programme, the Federal government entered into Performance Contract with the Boards of the commercialised public enterprises to ensure that management of the enterprises always acted consistently with the goals of the owners.

The Performance contract was introduced as a check on possible abuse of the increased autonomy granted the commercialised enterprises by commercialisation.

In furtherance of the need to continually address the principal-agent problem, the Securities and Exchange Commission (SEC) issued in 2003 a Code of Corporate Governance enshrining corporate governance best practices for Nigerian public companies. In that year, the Bankers' Committee also did same for Banks and other Financial Institutions in Nigeria. The Code predated the mandatory CBN Code for the sector issued in 2006, which was specifically aimed at addressing governance challenges arising from the consolidation of the banking sector in 2005.

The need for all these codes and regulations cannot be over emphasised. According to OECD (2004, P.30), corporate governance frameworks exert "key importance to overall economic outcomes" and "promote transparent and efficient markets". By affording companies the requisite flexibility and effective framework, corporate governance helps to enhance productivity, the creation of value-added and ultimately, the efficiency of the allocation of resources.

The purpose of this paper is to articulate theoretically the corporate governance system in Nigeria and its role in influencing firm/corporate performance and economic growth.

Towards this end, the paper is organised as follows: Following the introduction in part 1, part 2 focuses on the review of literature while part 3 examines the theoretical and analytical framework as well as the qualitative channels of the impact of corporate governance on economic growth. Part 4 presents the models featuring the quantitative impact of corporate governance on economic growth. Part 5 concludes the paper. It should be noted that this paper draws heavily on the works of Maria Maher and Thomas Anderson of the Organisation for Economic Cooperation and Development (OECD).

REVIEW OF LITERATURE

The academic literature on corporate governance as it impacts on economic growth is few and far between. However, the literature is replete with empirical evidence linking corporate governance to firm performance. It is the expectation both within OECD and non-OECD countries that good corporate governance could enhance corporate performance and lead to higher economic growth, through innovative activity, entrepreneurship and the development of an active small and medium enterprises (SME) sector. This section of the paper is largely a review of extant literature on corporate governance and firm performance.

Gugler (1999) provides a comprehensive survey of empirical studies of the effects of ownership concentration on corporate performance based largely on US and UK and ranging from the works of Berle and Means (1932) to the more recent ones by Leech and Leahy (1996) Prowse (1992), Agrawal and Knoeber (1996) and Cho (1998). He finds that majority of the studies was of the view that "owner-controlled" firms significantly outperformed "manager-controlled" firms. For purposes of the study, firms were classified as owner-controlled if there was a single block of equity exceeding 5 or 10 percent. The dependent variables used in those studies were all proxies for the performance of the firms as measured by net-income/net worth, rate of return on equity or Tobin's Q, or the riskiness of returns.

Empirical evidence also supports the hypothesis that large shareholders are active monitors in companies and that direct shareholder monitoring helps boost the overall profitability of firms. This result is also corroborated by studies of turnover of managers. For example, Franks and Mayer (1994) find a larger turnover of directors when large shareholders are present, again indicating that large shareholders are active monitors. This suggests that the beneficial effects of direct monitoring – more

overall profitability of firms – more than outweigh the costs of rent extraction by majority owners.

Maher and Andersson (1999) argue that given the low levels of ownership concentration in the US and UK relative to other countries, there is more direct shareholder monitoring, fewer restrictions for large shareholders which could improve firm performance in the US and UK, but that these results may not be the case in countries where ownership concentration is already relatively high. They further argue that once ownership concentration levels reach very high levels, then it is not clear that more monitoring will continue to improve things and may actually inhibit firm performance.

Roe (1994) states that the low ownership concentration in the US compared to other countries may be the result of policies initiated by controlling managers that discourage large holdings e.g. anti-takeover devices. This implies that for the US at least, that managers are strong relative to shareholders and that management entrenchment is a serious problem. The above conclusion based largely on the experience of the US and UK samples of firm data should be viewed with caution, as it is not necessarily transferable to other countries.

Zechauser and Pound (1990) argue that whether or not owner-controlled firms outperform manager-controlled firms does indeed depend on the type of industry. They find that the better performance of owner-controlled firms holds in industries with relatively low asset specificity (e.g. machinery and paper products), but there was no difference in industries with high asset specificity (e.g. computers). This suggests that the nature of the firm's investment and production decisions influence the asymmetry of information between principal and agent. For example, in industries where outside monitoring is particularly difficult, such as is the case in high asset specificity industries, large shareholders are less effective in overcoming agency problems. In this case, additional control mechanisms may be required.

In their analysis of several studies, Maher and Andersson (1999) hold that significant differences in the performance of owner-controlled versus manager-controlled firms are more likely in markets where the scope for managerial entrenchment is much higher i.e. in monopolistic or oligopolistic market structures. Weaknesses in corporate governance are more likely when firms are management-controlled and exert a high level of market power. One of the policy implications from these findings, they argue, is that development in corporate governance legislation should also feature competition and anti-trust policy.

THEORETICAL ISSUES AND ANALYTICAL FRAMEWORK

The term corporate governance has been used in many different ways and the boundaries of the subject vary widely. Theoretical literature is replete with definitions of corporate governance. However, the most well-known definition of corporate governance (CG) originates from the Cadbury Committee, which was set up in the UK in 1991 to raise standards in corporate governance: "Corporate governance is the system by which companies are directed and controlled" (Cadbury Committee, 1992). Corporate governance is about relationships and structures. First, it is the relationship between a company's management, its board of directors, its auditors, its shareholders, its creditors and other stakeholders. CG is based on structures through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

Recently, an International Federation of Accountants (IFAC) report gave the following definition for "enterprise governance".

.... the set of responsibilities and practices exercised by the board and executive management with the goal of providing strategic direction, ensuring that objectives are achieved, ascertaining that risks are managed appropriately and verifying that the organization's resources are used responsibly (IFAC, 2004).

For IFAC, enterprise governance has two dimensions that need to be in balance: conformance or conformity (i.e. with laws, codes, structures and roles) and performance. They believe that good corporate governance on its own cannot make a company successful. Companies must balance the two that is conformity and performance. However, without good governance, the long-term success of the company is put in jeopardy. In other words, good corporate governance is necessary but not sufficient for business success.

Other broader definitions would extend the concept of control beyond that exercised by the managers, the board of directors and the shareholders to a larger number of stakeholders, including creditors, employees and business partners, such as suppliers and the local community. The nub of corporate governance remains the relationships between management and shareholders with the auditors playing a key role. If the interests of all the relevant stakeholders are balanced, good corporate governance should maximise the shareholders' wealth and maintain the company's surrounding relationships.

Typical corporate governance structures usually address issues such as:

- roles of the CEO, and chairman;

- board of directors – composition, independence, qualifications, training, remuneration and representation of shareholders;
- audit committee – selection and role;
- rights and treatment of shareholders and stakeholders;
- external auditors – selection, duties, and liability;
- disclosure and transparency.

Before looking at the macroeconometric model linking corporate governance to economic growth, the paper presents in what follows a framework with which to understand how corporate governance can affect firm behaviour and economic performance. In the debate concerning the impact of corporate governance on performance, there are basically two different approaches or "models": the shareholder model and the stakeholder model:

The Shareholder Model

Under this model, the objective of the firm is to maximise shareholder wealth through allocative, productive and dynamic efficiency, i.e. the objective of the firm is to maximise profit. The criteria by which performance is judged in this model is the market value (i.e. shareholder value) of the firm. The overarching problem with this model derives from principal-agent relationship marked by the separation of the beneficial ownership (shareholders) from the executive decision-making (management). It is this separation that causes the firm's behaviour to diverge from the profit-maximising ideal.

Since the managers are not the owners of the firm, they do not bear the full costs, or reap the full benefits, of their actions. Therefore, although investors are interested in maximising shareholder value, managers may have other objectives such as maximising their salaries, growth in market share, or an attachment to particular investment projects, etc.

A major criticism of the model has been its implicit presumption that the conflicts are between strong, entrenched managers and weak, dispersed shareholders. That is why reform efforts, based on the model, have focused squarely on resolving the monitoring and management entrenchment problems which are the main corporate governance problems in the principal-agent context with dispersed ownership.

Under this model, three approaches have been used to align the interests and objectives of managers with those of shareholders to overcome the problems of management entrenchment and monitoring:

- align manager's interests with those of shareholders to induce managers to carry out efficient management e.g. executive compensation plans, stock options, direct monitoring by boards, etc;
- strengthening of shareholders' rights so shareholders have both a greater incentive and ability to monitor management;
- apply indirect means of corporate control such as that provided by capital markets, take-overs etc.

It is this preoccupation with aligning the interests of managers and shareholders that has attracted another critique of the shareholders approach, namely that the model's analytical focus on corporate governance problem is too narrow. Critics emphasised that shareholders are not the only ones who make investments in the corporation. The competitiveness and ultimate success of corporation is the result of teamwork that includes contributions from a range of different resource providers – investors, employees, creditors, suppliers, distributors and customers. Corporate governance and economic performance will be affected by the relationship among these various stakeholders in the firm. Hence, a broader analytical framework which includes all stakeholders is needed.

The Stakeholders Model

Under this model, the corporation is responsible to a wider constituency of stakeholders other than shareholders. Other stakeholders may include contractual partners such as employees, suppliers, customers, creditors and the local community in which the firm is located, local and national governments and society at large. This model holds that corporations should be "socially responsible" institutions, managed in the public interest. In this model, any assessment of the implications of corporate governance on economic performance must consider the incentives and disincentives faced by all participants who potentially contribute to firm performance. This is necessary because the stakeholder model holds that corporate governance is primarily concerned with how effective different governance systems are in promoting long term investment and commitment amongst the various stakeholders.

However, only few academics, policy makers or other proponents of corporate governance reforms still espouse this model, considering that it fails to give clear guidance to help managers and directors set priorities and decide among competing socially beneficial uses of corporate resources.

Good corporate governance, according to Kwakwa and Nzekwu (2003) seeks to promote certain ideals which include:

- Efficient, effective and sustainable corporations that contribute to the welfare of society through the creation of wealth, employment as well as solutions to emerging challenges.
- Responsive and accountable corporations.
- Management with integrity, probity and transparency.
- The recognition of the rights of stakeholders.
- A leadership and management approach which is inclusive and based on democratic ideals, legitimate representations and participation.
- Fairness, efficiency and transparency in administration to meet the objective of the corporation.
- An efficient process to create value, add value and optimise profit.

Therefore, good corporate governance must make sure that a company offers a fair return for each stakeholder's input. This ensures good business where investors, employees, suppliers and other contributors to a company's activities receive fair return to their contributions. Good corporate governance also ensures proper balance in the management of different interests which may be conflicting. These include the interest of management employees, shareholders, and the society at large. Moreover, where good corporate governance is exercised, the board earns and enjoys the trust of all the parties concerned. For this to happen, the board must exhibit a high level of independence and objectivity. It must keep faith with the stakeholders and honour the company's obligations with fairness and consistency especially in meeting its corporate social responsibility.

Furthermore, good corporate governance demands that the board of a company show readiness to subject its own actions and performance to scrutiny and critical appraisal by the other stakeholders. (Molokwu, 2003)

The commonwealth secretariat has provided a checklist of policy issues for strengthening corporate governance and risk management, especially in the financial sector. These include:

The development of an effective legal framework which specifies the rights and obligations of a company, its directors, shareholders and other stakeholders; specifies disclosure requirements and provides for effective enforcement of such legal provisions.

The specification of the rights and powers of shareholders and other stakeholders, such as creditors, including rights in relation to voting and access to information on the company.

Requirements for identifying and dealing with directors' conflicts of interest.

Specification of the disclosure obligations of the company.

This includes the preparations of financial statements, maintenance of accounting systems as well as audit arrangements. The law of a company is expected to specify an obligation on the part of directors to issue financial statements in relation to their company and the group of which it is part. The Directors of a company are held liable for ensuring that the bank's financial statements and other disclosure are not false or misleading.

There is need for a well-resourced government authority with the power and capacity to enforce breaches of corporate law, and legal system and judiciary capable of facilitating effective enforcement, including enforcement through civil claims.

Penalties for non-compliance with governance arrangements.

The government agencies responsible for enforcement, and the judiciary, need to be accountable for the exercise (or non-exercise) of their powers. Accordingly, structures to facilitate their accountability should be in place, including transparency arrangements with respect to the nature and performance of their responsibilities.

Arising from the above discussion, we attempt to specify two models incorporating governance and economic growth.

CORPORATE GOVERNACE AND ECONOMIC GROWTH

Given the acceptance that good corporate governance enhances economic growth, we now extend our standard long-run growth model growth equation endogenizing and expanding corporate governance:

A. $y = f(k, L; Gc, A)$ A1

Where:
y = output
k = Capital
L = Labour supply
Gc = Corporate governance
A = Total factor productivity

Hence, growth in output could stem from capital formation, improvement in the quantity and quality of labour through education and skills development as well as

good corporate governance which in this case is endogenized in the growth equation. All the explanatory variables positively influence economic growth, a priori.

The corporate governance variable can furner be stated as follows:

Gc = g(Ac,Sr, Er, T,V) A2
Where:
Ac = Accountability
Sr = Corporate Social Responsibility
Er = Efficient use of resources
T = Transparency
V = Value for money

It is assumed that good corporate governance is an increasing function of each of the explanatory variables in equation A2.

B. Dynamic Model:

In analysing the impact of corporate governance on economic growth, we use the following standard autoregressive dynamic model:

GDP	=	$\alpha_0+\alpha_1\Delta CGQ_{t-1}+\alpha_2 GDP_{t-1}+\alpha_3 X_t+\mu_1$	.... B1
TFP	=	$\beta_0+\beta_1\Delta CGQ_{t-1}+\beta_2 TFP_{t-1}+\beta_3 X_t+\mu_2$	.... B2
TFP	=	$C_0+C_1\Delta CGQ_{t-1}+C_2 TFP_{t-1}+C_3 X_t+\mu_3$	.... B3
Inv/GDP	=	$d_0+d_1\Delta CGQ_{t-1}+d_2(Inv/GDP)_{t-1}+d_3 X_t+\mu_4$	.... B4

Where:

GDP	=	**GDP growth rate**
TFP	=	Total Factor Productivity growth rate (based on the standard method used by Klenow and Rodriguez-Clare (2005)
TFP	=	**Total Factor Productivity level**
Inv/GDP	=	Investment-to-GDP ratio.
ΔCGQ index	=	the change in the vector of its components, and it is lagged since we assume it takes time to translate the effects of a change in corporate governance in a given year into macroeconomic outcomes e.g. GDP via its autoregressive term.
Δ	=	change operator

CGQ index is a simple average of three indicators, called Accounting Standards (AS), Earning Smoothing (ES) and Stock Price Synchronicity (SPS). These indicators are constructed from accounting and market data for samples of non-financial companies listed on the stock market.

AS = Amount of accounting information firms disclose
ES = Based on computations of accruals (AS) and cash flow from operations (CF).
AS = $(\Delta CA_t - \Delta Cash_t) - (\Delta CL_t - \Delta STD_t - \Delta TP_t) - Dep_t$

Where:

CA = Current assets
Cash = Cash and cash equivalents
CL = Current Liabilities
STD = Short-term debt
TP = Income tax payable
Dep = Depreciation and amortisation
SPS = Stock price synchronicity is the average goodness-of-fit (R^2) if regressions of each company's stock return on country-average return in each year.
X_t = denotes a vector that includes all other variables that affect GDP, TFP or Inv/GDP
GDP_{t-1} = lagged valued of GDP growth to control for business cycle effects.

A priori Expectation

In the light of intuitive reasoning, we expect that improvements in corporate governance quality as represented by an index ΔCGQ in a given year could impact positively on firm performance or value-added, thereby contributing to economic growth. Thus, the parameters α_1, β_1, C_1 and d_1 are expected to be positive (α_1, β_1, C_1 and $d_1>0$). A fortiori, all the other parameters/regression coefficients in equations (1) – (4) are expected to be positively signed.

The paper is silent on results of implementation of the econometric model based on Nigeria's data. The lack of data on most of the variables makes the testing of the model difficult. The computation of data for the corporate governance quality index, for example involves prior data estimation of Accounting Standards, Earning Smoothing and Stock price synchronicity, with considerable resort to data mining. Consequently, the paper is unable, at this point, to confirm or disconfirm, in

quantitative terms, the impact of corporate governance on Nigeria's economic growth.

CONCLUSION

This paper has analysed the issues in corporate governance, especially those relating to impact of improvements in corporate governance on firm performance and economic growth. In this regard, it has reviewed two major strands in the debate concerning the impact of corporate governance on firm performance, namely the shareholder model and the stakeholder model.

In its narrowest sense (shareholder model), corporate governance often describes the formal system of accountability of senior management to shareholders. In its widest sense (stakeholder model), corporate governance can be used to describe the network of formal and informal relations involving the corporation.

It has also discussed the accountability issue, canvassed in the shareholder model, outlining three broad types of mechanisms that can be used to align the interests and objectives of managers with those of shareholders and overcome problems of management entrenchment and monitoring: putting in place executive compensation plan, stock options, direct monitoring by boards, etc., in order to induce managers to carry out efficient management; strengthening of shareholder's rights so shareholders have both a greater incentive and ability to monitor management; and using indirect means of corporate control such as that provided by capital markets, managerial labour markets, and markets for corporate control e.g. take-overs.

The paper notes that, more recently, the stakeholder approach emphasises contributions by stakeholders that can lead to the long term performance of the firm and shareholder value, and economic growth. Therefore, it is of the view that the difference between shareholder model and stakeholder model is not as sharp as it first seems and it is instead a question of emphasis.

In their analysis of results based on several studies, Maher and Andersson (1999) note that significant differences in the performance of owner-controlled versus manager-controlled firms are more likely in markets where the scope for managerial entrenchment is much higher i.e. in monopolistic or oligopolistic market structures. Weaknesses in corporate governance are more likely when firms are management-controlled and exert a high level of market power. One of the policy implications from these findings, they argue, is that development in corporate governance legislation should be done together with that in respect of competition and anti-trust policies.

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