

Institutional Voids and Corporate Governance: A Conceptual Understanding

Umar Burki¹

¹ Vestfold University College, Norway

Correspondence: Umar Burki, Department of Business and Management, Vestfold University College, P.O. Box 2243, N-3103, Norway. Tel: 47-3303-7757. E-mail: Umar.Burki@hive.no

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Abstract

Asian business firms and their fundamental business institutions are primarily embedded in socio-cultural features. This institutional void argument outlines the indispensable role of informal Asian business institutions in managing corporate governance. Under this argument, the study draws attention to the development of business groups and networks in Asia and elucidates why Asian business groups and networks are important elements regarding practical and operational dimensions of the Asian corporate sector. These uniqueness Asian business characteristics are expound in relation to salient assumptions of different theories to understand and provide practical knowledge about corporate governance choices made by Asian family firms.

Keywords: institutional void, corporate governance, Asian family firms, business groups, networks

1. Introduction

The notion of corporate governance defines a combination of relationships between stakeholders, mainly composed of a company's management, its board and its shareholders to improve organizational efficiency and market competitiveness (Gompers et al., 2003). To develop and sustain an orderly corporate governance mechanism in any country, a necessary condition is to develop an orderly market mechanism under that proper rules and regulation that are framed to standardize and protect the activities and legitimate rights of companies and stakeholders (Hua et al., 2006). For achieving greater transparency between the principal stakeholders, corporate governance should be achieved through main corporate governance elements such as board supervision, auditing process and financial disclosure as well as institutional and societal arrangements (Deakin and Hughes, 1997).

Corporate governance approaches are also deeply influenced by the historical, political, industrial, social and cultural contexts of a country (Hua et al., 2006). These contextual elements are relevant for efficient corporate governance because they help in reducing the uncertainties associated with economic transactions. Under such contextual elements, it is reported that corporate governance varies across countries (Lubatkin et al., 2005). Most of the corporate governance studies have been conducted in the Western business context (La Porta et al., 1999) and trivial research efforts have been made to examine corporate governance in Asia. It has been argued that developing/emerging Asian economies have weak corporate governance (La Porta et al., 2000). Moreover, Asian family firms operate in business environments where legal institutions are either weak or non-functional, and informal institutions dictate governance mechanisms. Consequently, personalized and relational aspects govern corporate governance in the Asian business context, while arm's length rules are followed in the Western corporate governance context (Carney and Gedajlovic, 2001).

A combination of institutional void argument and preference for relational characteristics accentuate the need to examine whether the Western theories can appropriately explain corporate governance behavior in an Asian context. Asian family firms operate in very unique business environs and rely considerably on informal institutions such as business groups and networks (Hitt et al., 2002). The objective of this study is to examine the dependability of Western governance theories in the Asian business environment. To justify our research objective, this study outlines and accentuates the role of institutional voids in creating business groups and networks, and their possible role in illuminating corporate governance mechanisms regarding Asian family firms.

This paper is organized as follows. The next section provides the theoretical background about institutional voids, business groups and networks in Asia. In the subsequent section, the chosen theoretical main foundations are

discussed in relation to family firms' logics concerning corporate governance practices. This discussion underpins the conceptual foundation of our paper, followed by a conclusion.

2. Background

In general, most of the corporate studies follow the Anglo-American corporate scheme of arm's length, market and rule-based model (Allen, 2000). Despite its imperfections and being in sharp contrast to "know-who model" applicable in the Asian corporate settings, the Western model sets the standards for an effective corporate governance mechanism (Hua et. al., 2010). It is also important to remember that corporate governance is contingent upon the presence of formal and informal institutions (Tam, 2002). This dimension becomes more pertinent in assessing corporate governance parameters for economies that are generally characterized by institutional voids (Khanna and Palepu, 2004). Under the paucity of strong formal institutions, most of the Asian economies rely heavily on informal institutions for governing corporate and business issues (Peng, 2002). It is also important to remember that the Asian business landscape is dominated by small, large and publically traded business firms that are either owned/controlled by business families or are a part of business groups that are embedded in the socio-cultural features (Peng and Jinag, 2010). Based on this contextual factor, it has been reported that Asian firms and their informal Asian institutions affect corporate governance mechanisms (Ghani and Ashraf, 2004).

It is important to have the requisite understanding about the institutional void argument, the socio-cultural dynamic of Asian family firms and informal Asian institutions before connecting them with corporate governance mechanism. The subsequent sub-sections describe and outline how presence of institutional void and Asian family firms' characteristics affect corporate governance.

2.1 Understanding Institutional Void

Institutions are described as cognitive, normative and regulative structures that provide stability and significance to social behavior (Scott, 1995). Moreover, institutions are country-specific and are categorized as formal and informal institutions (North, 1990). Formal institutions refer to written laws, policies, rules and regulations that govern socio-economic and political aspects of a society, whereas informal institutions refer to the social factors shared by the members of a society that serve as constraints and/or standards, and the violations of that entails social rather than legal penalties (North, 1990; Roxas et al. 2008).

Formal institutions are effective in those economies where a) government assures exchange actors that exchange environment will be relatively free from corruption and the rule of law will be followed, and b) contract implementation is rationally foreseeable (Khanna and Palepu, 1997). Whereas informal institutions become pertinent in those economies where exchange actors anticipate that contract implementation is fragile due to deficient legal framework (Khanna and Palepu, 2000). Under conditions where formal institutions become inefficient due to legal or market imperfections, informal institutions become important in reducing uncertainty and enhancing reliability between social and business actors (Khanna and Palepu, 1997; Peng, 2002).

The development of institutional void is multifaceted in the Asian business environment. It is due to the reasons that on the one hand, formal institutions fail to provide a credible legal framework, and on the other hand, there is an absence of stable political setup, affecting governments functioning and markets operations (Peng, 2002). That is why there is a heavy reliance on informal institutions and personal ties in Asian markets to accomplish corporate targets (Hitt et al., 2002; Peng, 2002). Nevertheless, the basic Asian corporate governance elements such shareholders, board of directors and professional managers apparently seem similar to Western (e.g. USA and EU) corporate equivalents (Peng, 2000). But in reality, these visible Asian corporate elements are present more as structure than as ingredient. This dichotomy can be attributed to the institutional environment because regulatory legal framework governing Asian markets and institutions fail short of providing support to business transactions (Peng, 2002). This further indicates that the Western formal corporate governance practices may appear similar but quite different when it comes to practice in Asian business environments. In other words, this implies that in Asian corporate environment, there will be an increase in transaction costs, uncertainty and slow information flow. In order to avoid such exchange hazards, business transactions should be internalized between business partners (Williamson, 1990).

This theoretical premise is followed by Asian family firms where there is no separation between ownership and control, and the firm's management is firmly in the hands of the owning family (Chen, 2002). Relational ties, kinship connections, and government contacts are pursued by Asian business firms because they play an extra and resilient role in the functioning of Asian corporate governance (Peng, 2000). Trust is the central element in these connections and provides the necessary credibility required for smooth functioning (Chen, 2001). Moreover, it is through these trustworthy connections that informal institutions are able to provide incentives and

enforced constraints on economic actors (Roxas et al. 2008).

Culturally, Asian countries are collectivistic in nature where trust is person specific (Hofstede, 2004). This underlines that the social context of an Asian society is embedded in the norms of mutuality and reciprocity between actors that are usually family members and close friends. This cultural logic also underlines the basis of Asian's informal institutions, where a premium is placed on nurturing strong interpersonal ties/relationships. This is why business groups and networks are the two important informal institutions that Asian family firms develop and rely on for corporate governance and business success (Park and Luo, 2001). On the one hand, these informal institutions help Asian firms in minimizing exchange hazards' possibilities, and on the other hand, they facilitate their business transactions.

2.2 Understanding Family firms

Family firms have been defined on the basis of different family characteristics (Castro and Casasola, 2011), levels of family involvement (Astrachan and Shanker, 2003) and others family firms dimensions. Chua et al. (1999) defines a business to be a family business that pursues a certain business vision held by a dominant alliance controlled by family members or a small number of families in a manner that it is sustainable over a period through family generations. Family firm is the leading form of business in the world (Peng and Jiang, 2011). For instance, eighty five percent of all US businesses are family owned (Yu, 2001). Nevertheless, family firms have a very prominent place in Asia. For instance, ninety nine percent of all private sector Indian business firms are family owned (Iyer, 1999).

Asian family firms are distinctive different from the other family firms of the world because they follow a very strong socio-cultural and religious value system that is embedded in the elements of trust and loyalty (Reddy, 2009). In general, Asian businesses are established and headed by male members of the family, and they are the major decision-makers. Usually, the father or eldest male member of the family endeavors on behalf of the family, and he enjoys unquestionable authority (Song et al., 2005). That is why typical Asian hierarchical and patriarchal values have also become an integral part of Asian family firms. For instance, the president is the father and the older brother/s is in upper level management and the younger brother/s or son/s is in lower management in Korean organizations (Song et al., 2005). The presence of a powerful father figure, paternalism and extensive use of networks are the characteristics of a typical Chinese family firm (Yu, 2001). The family firms of Pakistan are also characterized by a paternal head, a large power distance between the top and lower levels of management, and the decision-making authority located at the top (Khilji, 2004).

Consistent with the above mentioned characteristics of Asian firms, social networks and business groups are the two most dominant informal institutions that Asian family firms develop and rely on for carrying out corporate tasks (Peng and Jiang, 2011; Sikorski and Menkhoff, 2000). As these informal institutions are based on trust, loyalty, respect for hierarchical relationships and strong interpersonal relations with the group and family (e.g., Park and Luo, 2001), it is postulated that these informal institutions have a substantial effect on corporate governance mechanisms in Asia. The underlining dynamics of business groups and networks is explicated, as follows.

2.2.1 Business Groups

A business group is interpreted as an inter-firm organization that is formed in response to market imperfection (Leff, 1978). A business group is also defined as a business entity that is legally independent but is bounded together with other business firms by a number of formal and informal ties (Khanna and Rivkin, 2000). It is reported that fundamentally, the paucity of formal institutions is considered responsible for the emergence of business groups (Heugens and Zyglidopoulos, 2008), and likewise this study's argue that existence of business groups sustains the paucity of formal institutions. The literature (e.g., Encarnation, 1989) further elaborates that business groups are affiliated together through strong social ties based on family, caste, religion, language and ethnicity.

Japanese keiretsu, Korean cheabol and, Chinese and Indian sub-continent family businesses are the best examples of Asian business groups. The inner core Asian business group is built on conducive and close relationships. For example, the organizational structures of Japanese business groups, keiretsu, are pyramidal and tightly controlled by the lead firm and the lead bank (Kienzie and Shadur, 1997). In order to keep and maintain bilateral trading within business groups, Japanese business groups place a high value on preferential relationships. Dore (1983) showed that the groups provide protection from market failure and keep a check on bargaining superiority of high keiretsu members. Furthermore, these informal networks are present in institutional form at many levels of Japanese society and ensure group stability and individual commitment to the group.

The Korean cheabol is owned and controlled by a family and its members with low levels of formal coordination (Yu, 2001). They are vertically integrated and control diverse activities through a common hierarchical setup (Kienzle and Shadur, 1997). Likewise, Chinese business groups or networks are based on familial and ethnic ties and characterized by simple organizational structures with centralized decision-making by the owner-cum-manager (Kienzle and Shadur, 1997). Chinese family business networks do not rely on formal contracts, and personal trust is used for financial and other network transactions.

In South Asia, business groups are community based. In the Indian subcontinent (e.g. India and Pakistan), the business community is considered socially complete because the merchant communities are divided along social, religion, ethnicity and regional lines that have interesting effects on the nature of inter-firm transactions. For instance, the prominent business communities of Gujratis, Khojas, Chinotis, Sethis and Parsis of the Indian Sub-continent make use of ready-made networks of credit and capital based on religious and caste origin (Iyer, 1999). After the partition of Indian Subcontinent in 1947, some of the business families in India migrated to the newly established state of Pakistan. This is one of the many reasons that the Indian and Pakistan business environments are governed by similar types of informal institutions.

2.2.2 Networks

The notion of social networks underlines that economic actors are influenced by the social context in which they are embedded, and their position in the social network (Gulati, 1998). Like the emergence of business groups, a general absence of security and lack of trust are outlined as the main rationale behind the emergence of networks (Yu, 2001). Networks are highly trusted by common people because they are based on a set of codified rules that emphasize the notion of community, reciprocity, hierarchy, loyalty and a deep sense of collectiveness in the interdependent relationships (Hitt et al. 2002).

The Asian networks are built on a cultural platform and explicate which type of behavior is appropriate for a specific setting (Alston, 1989). Given that they have an all-encompassing nature in the Asian context, they cover every facet and fiber of a society including business relationships (Park and Luo, 2001). It is reported that the main foundations of Asian business networks are based on connections through family, race, religion and profession (Kienzle and Shadu, 1997). In a nutshell, social networks are made up of a web of interpersonal connections that govern personal behavior and social personal relationships. Networks provide Asian business firms a range of competitive advantages in the form of vital information about local markets, business partners, and other prominent members of local areas (Sikorski and Menkhoff, 2000).

The philosophy of Asian networks follows the in-group approach, a unique cultural feature under which Asians have a deep sense of in-group affiliation (Leung, 1987). In-groups are usually typified by similarities between group members and there is a strong sense of common fate within the group members (Chen and Li, 2005). Group distinction is an essential feature of Asian societies and seems to affect each and every norm of interaction. That is why trust at the individual and the collective level is of paramount importance in Asian societies (Lim, 2000). Asian networks are also based on this in-group distinction where reciprocity plays a vital role in promoting harmony and integrity within the group, essential for organizing and protecting business interests in Asia.

Based on this approach, a large number of networks are functioning in Asian societies. The underlining role of these networks is to facilitate and promote a favorable environment for business transactions. Moreover, these concepts define hierarchy, loyalty to group and filial attitudes toward subordinates in both the business as well as in the social context of Asian societies (Alston, 1989). For instance, *wa* and *inhwa* are the social networks that are employed respectively by Japanese and Koreans firms to manage businesses interests (Alston, 1989). Similar concepts like *amae*, *inmal*, and *kankei* also emphasize the role of interpersonal relationships, hierarchy and protection of harmony in the management of business relationships. In South East Asia, *budi* and *pakikisama* are the dominating social networks in Malaysia and the Philippines. Both these networks emphasize the notion of community, nurturing cooperation and a sense of collectiveness (Storz, 1999). Similarly, *guanxi* is a Chinese network that is omnipresent in all business dealing in China (Luo, 2002).

In the Indian-Pakistani business context, *jan-pehchan* and *apane-aur-paraye* (Zhu et al., 2006; Kumar and Sankaran, 2007) are the two commonly used networks that augment and facilitate business transactions. *Wasta* is an Arabic relational term that involves a social network of interpersonal connections rooted in ties to family and kinship (Hutchings and Weir, 2006). *Wasta* is a central characteristic in the social and business operations in all the Middle Eastern countries (Hutchings and Weir, 2006). In many ways, it resembles the Chinese system of *guanxi*.

In general, Asian family firms are customary and risk averse (Gomez-Mejia et al., 2007). In order to avoid and

overcome any business uncertainties when established law fails to support transactions in reliable manner, Asian family firms rely profoundly on informal structures such as business groups and networks that are built on the core components of trust and loyalty with family, close friends and governmental official. Moreover, Asian family firms have some distinct intangible characteristics such as familial or familiness, paternalism, ownership of family assets, and extensive business networks (Huybrechts et al., 2011; Yu, 2001). These features are instrumental in the creation of social capital (Hitt et al., 2002) and socio-emotional wealth (Ducassy and Prevot, 2011) for Asian family firms. In the Asian context, social capital is interpreted as relations or a network of relations among individual or organizations those facilitates actions and creates value (Hitt et al., 2002). While socio-economic wealth is referred to the non-financial aspects of family firms that incorporate emotional traits like identity, benevolence, the ability to use family influence and the desire for permanence (Ducassy and Prevot, 2011).

Social capital and socio-economic wealth are the core operational elements of Asian business groups and networks to fortify family firms in their social construct and also provide them with competitive advantages. In other words, they become the intangible assets for family firms which are unique, rare, valuable and hard to substitute (Barney, 1991). Our study takes this underlying dimension of informal institutions to discuss the relevance and application of theoretical approaches in understanding corporate governance in the Pakistani context. This view will help in developing a better understanding about corporate governance mechanisms in economies where institutional voids are dominant.

3. Corporate Sector Governance: Theory vs. Practice

Examining corporate governance in the Asian context under different theoretical perspectives is eloquent in three manners. First, different theoretical perspective are likely to give a better understanding about corporate governance research in the Asian context particularly when one considers the dominating role of family firms and their business structures. Second, the analysis demonstrates that understanding corporate governance in Asia entails integrating different theoretical perspectives with the real Asian institutional environment. And lastly, this reflection will enhance and develop a better understanding about Asian firms' corporate governance. We initiate our discussion by outlining the essential idea of the chosen theoretical perspectives, and then discussing it in relation to corporate governance of Asian family firms.

As preceding discussion outlines that Asian family firms are simultaneously embedded in and exposed to informal institutional environment. Corporate governance has both economic and sociological dimensions (Williamson, 1985). The economic dimension focuses on economic efficiency, while the sociological dimension focuses on social legitimacy (Peng, 2002). It is important to examine this dual dimension of corporate governance in the context of institutional economics. In the presence of dysfunctional formal institutions and dominating socio-cultural embedded business groups and networks, Asian family firms will have a high level of confidence on those corporate governance arrangements that augment the already existing family firm's social capital, and help in reducing uncertainty and providing reliability. Both these corporate dimensions are paramount because it is important for Asian family firms that they are able to demonstrate simultaneously economic and social legitimacy. Business groups and networks provide this dual legitimacy by simultaneously facilitating pecuniary efficiency and social legitimacy as required under Asian corporate systems.

Taking the institutional framework further, transactional cost analysis provides another way of viewing the role of informal Asian institutions in corporate governance. Built on the market failure argument, transaction costs analysis deals with ex post problems that are generated due to the presence of specific assets, uncertainty and opportunism (Williamson, 2000). Informal Asian institutions in functionality can be treated as specific assets since they are built and sustained on by the social capital, that draws its strength from the pool of social and business connections. This implies that Asian firms' social relations are valuable assets with high sunk costs and due to their ingrained characteristics, they are hard to substitute. As there is no separation between commercial and social aspects in Asia, Asian firms utilize these inter-firm assets for producing and sustaining commercial advantages.

Asian family firms confront a very complex situation where they have to keep a balance between the traditional Western corporate system and the traditional Asian corporate system. The latter system is embedded in networks composed of market, familial, ethical and social relations and their particularity in daily business transaction. Asian firms fulfill their economics and social obligation associated with the traditional Asian corporate management in such a manner that firm's relationships with mainstream stakeholders and the mutual strategic social capital remains intact. Concerning the Western corporate governance mechanism, Asian firms follow it in a style where it seems that the actual spirit of the system is being followed. In actuality, it may be true but

nevertheless, the corporate decisions made under this system also stem from the traditional system and there is a strong emphasis on maintaining strategic relationships with and within business groups or networks.

Efficient corporate governance demands absence of uncertainty and opportunistic tendencies. In any business transaction, transaction costs emerge when trust is absent between business partners. Due to this notion, Asian firm owners are the majority shareholders and have higher levels of trust between themselves than between majority shareholders and minority shareholders. This means that the success of corporate governance is dependent on high levels of trust, a stringent prerequisite to fulfill between majority shareholders and minority shareholders in an Asian society (Fukuyama, 1995). Similar anxieties underline between majority and minority shareholders when it comes to the formulation of board of directors, professional managers and appointment of CEOs. The main reason behind this rationality is that Asian firms apply corporate governance tools in such a manner that they try to achieve commercial as well as social efficiency. In doing so, they rely on informal institutions because they help them in mitigating uncertainty and opportunism tendencies between business partners.

The resource based view (Barney, 1991; Matta et al., 1995) proposes that a firm's performance is founded on certain kind of resources which are hard to imitate and thereby providing sustainable competitive advantage. Resource based view literature (e.g., Huybrechts et al., 2011) identifies business groups and networks as the two intangible resources that gives family firms competitive advantage. Business groups and networks provide the necessary mechanism to carry out Asian corporate governance under the notion of structural embeddedness (Yu, 2001), highlighting that when formal institutions fail, replacing institutions provide rules of business. In the Asian context, corporate governance has to examine the interaction context of familiness (Huybrechts et al., 2011) where the family, the business, and a number of unique resources intermingle. All these elements are essential in creating social and family capital, important intangible resources of family firms. Therefore, it is not surprising that family capital is composed of indispensable family characteristics such as obligations and expectations, reputation and moral infrastructure (Huybrechts et al., 2011). The presence of social and family capitals implies that in order to achieve corporate governance, Asian firms have to incorporate different social elements such as family reputation and organizational decision making arrangement with the commercial elements. This aspect underlines the reason why it is not crucial for Asian firms to follow concrete rules and regulations as stipulated under the Western corporate governance structure.

The agency theory is primarily about the moral hazards when ownership is separated from control and the focus is on the incentives for shareholders. Agency theory further advocates that when ownership and control are separated, professional managers should be appointed. Under corporate regulations, Pakistani family firms fulfill this requirement and employ professional managers but their role is only to perform as a policy implementing manager rather than a policy making manager. The variation in the role of professional managers emerges because primarily, Asian firm owners prefer to run their firms directly in the first place. Based on their uncertainty sensitivities about alien and non-family managers, they want to avoid any agency problems connected to power abuse, misappropriation, etc. in relation to other strategic network shareholders.

4. Conclusion

In general, corporate governance is measured by using parameters such as firm value, profit distribution, family ownership and control, shareholders, etc. (La Porta et al., 1999). This paper examines the theoretical relevance of business groups/networks in evaluating corporate governance. As discussed earlier, business groups and network structures are not only organizational in nature but essential for the formation of social capital that plays a vital role in generating and sustaining positive economic competitiveness and social benefits for Asian firms and their strategic allies. The discussion underlines that the relational embedded ties (Granovetter, 1985) play a vital role in understanding and managing corporate governance when the institutional void argument is taken into account in Asia.

At the same time, it is important to remember that relational or "who you know" corporate governance system has its own drawbacks. It is due to the heavy reliance on this system along with weak legal framework and rampant corruption that lead to the famous 1990s Asian financial disaster. All these factors were instrumental in developing cronyism. Driven by economic greed and lust for power, Asian governments (whether civil or military), politicians, government officials and selected Asian business families acted together their connections to rob minority shareholders' savings. Overtime, all these Asian families/actors in the corporate sector have further intertwined in complex networks of commercial and non-commercial interests. These networks are employed to extend the boundaries of formal business ties to nuptial ties and are used as a bridge to move from corporate arena to civil, military bureaucratic and political circles. Under this promulgation process, these

networks provide huge socio-economic advantages to families/groups in all of the spheres of life but particularly in areas such as economic, social and political.

In the presence of institutional voids, Asian economies' gains have been localized to such networks and have provided the impetus for the vicious circle of abnormal profit for the members of such family/business groups/networks. That is why it is observed that in most of the Asian economies, key politicians, member of military establishment and civil bureaucracy ensure to perpetuate and sustain deep rooted cronyism. International agencies such as World Bank and the CPI of Transparency International also report that the presence of sustained institutional void has led to "the uninterrupted cronyism" and is the main disease why several Asian economies still lack impetus for a sustainable growth.

4.1 Managerial Implications

This study provides the reasoning to managers why the effectiveness of business contracts is difficult to guarantee in certain economies. China is one of the largest economies of the world. In spite of its adoption to Western corporate procedures and norms, the compliance of business contracts is subjective to informal networks such as guanxi. Similarly mechanisms are followed in most of the economies located in Asia, Africa and South America because they have greater faith on informal institutions when it concerns managing business transactions.

4.2 Limitations and Further Studies

Like other studies, this study also has its limitations. Although this study does not incorporate the arguments where informal institutions fail to protect the interests of minority stockholders and thereby end supporting cronyism tendencies. A more elaborative view about theoretical perspectives would further support the relevance of this study in measuring corporate governance. By highlight the dynamic roles of business groups and networks in corporate governance, this paper does provide a different conceptual perspective for examining corporate governance. An empirical investigation the effect of institutional voids and family firms' on corporate governance structure would be an interesting area for further research.

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