

Adaptive Accountability: Toward a Culturally Compatible Model of Corporate Governance for East Asia

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Introduction

▶ *The Nature of this Exercise*

- So we have good reason to assume that North-East Asian societies are indeed "different" from Western societies, or at least from the US.
- My goal here is to suggest directions for harnessing these insights for the design of corporate governance mechanisms.

▶ *The Central Idea*

- Corporate governance is a social institution. To be effective, it must be compatible with the surrounding social environment. Yet it must also respond to global financial markets.

▶ *An Attack on the Citadel*

- Over the last decade, a common wisdom has developed on how to improve corporate governance. A virtually unanimous policy holds: Enhance accountability.
- I try to challenge the wisdom underlying this policy. Accountability, properly understood, is not a universal mode of governance. Accountability depends on certain cultural values and beliefs.
- Design strategies: Adapting accountability to social circumstances or developing alternative, culturally compatible mechanisms of governance.

Modes of Corporate Governance Reform

▶ *The Agency Problem is Universal*

- The basic postulate in corporate governance analysis: The combination of self-interestedness ("rationality") and ubiquitous information asymmetries creates a socially destructive incentive scheme – the agency problem.
- Governance is needed to curb "excessive" (socially unacceptable) abuse of power, but cannot eliminate it.
- Make no mistake: No society is a City of God, or Nirvana.

▶ *Convergence of Substance*

- Gilson distinguishes convergence of substance from convergence of form in the dynamic development of corporate governance systems. Arguably, the two dynamics would lead to equally effective results.
- Convergence of substance is evolutionary. It tends to be slower. It is more path dependent, or "organic." Arguably, it is also more susceptible to political economy – entrenched interests (Bebchuk & Roe).

▶ *Convergence of Form - Transplantation*

- The "historical accident" – colonial heritage.
- The "quick fix" – (quasi-)voluntary adoption – Japan in 1896, 1950; CIS in 2002; Korea in 2001; China in 2006.

Accountability as a Core Principle

▶ *Codes of Principles*

- OECD Principles of Corporate Governance (1999, 2004)
 - ▶ VI. The Responsibilities of the Board – The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.
- A template for scores of codes of best corporate governance principles around the world.

▶ *Example*

- President Bush, in the wake of Enron-WorldCom: "We can have all kinds of rules, and we will. I mean, I laid out some initiatives... that will hold people accountable. And our Justice Department will hold people accountable."
- The Sarbanes-Oxley Act was originally entitled the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002.

▶ *Legal Reforms in Korea and China*

- Japanese/German statutory infrastructure. Corporate officers are subject to the duties of a "good manager".
- Recent reforms added a US-inspired duty of loyalty. This duty hyperlinks to the full baggage of common law accountability of fiduciaries.

The Origins of Accountability

▶ *An Anglican Term*

- "Accountability" is known only in English. A "state of being responsible or answerable" (Black's); "Liabl[ity] to be called to answer for responsibilities and conduct" (Oxford). Other European languages use "responsibility".
- Japanese: "akauntabiritii"; Hebrew: "akauntabiliyut"
- Dubnick: Accountability is an Anglican term.

▶ *History*

- Relatively little is known.
- Dubnick [poli-sci]: Origins go back to William the Conqueror's Domesday Book of 1086 and Henri II's accountability to local nobility.
- Seidman [law]: The early English Kings, unlike many of their continental counterparts, had to learn the art of compromise.
- In the 13th and 14th century there were several attempts to constrain royal powers and make public ministers accountable to Parliament and 'the nation' rather than to the King alone.

The Meaning of Accountability

▶ *It's about Power – about Governance*

- A mode of governance – a mechanism, a style for restraining power to socially acceptable levels - a particular answer to a universal problem.
- The unique feature: governance is exerted from below, not from above – the fiduciary is accountable to the beneficiary, not [only] to the superior.
 - ▶ Each of these terms is laden with English legal connotations.

▶ *Private Accountability*

- In common law, power relations – from simple agency and upward – are fiduciary relations (R2A §1) – trigger a duty of loyalty.
 - ▶ No action under conflict of interests
 - ▶ Full disclosure
- Corollary: No [secret] private benefits from power, e.g., corporate opportunity.
- Corollary: Full restitution (unjust enrichment, not damages) - no impunity.

▶ *Public Accountability*

- "Accountability is an elusive concept" (Behn).
 - ▶ Public justification for exertion of power
 - ▶ Disclosure
- Corollary: No [secret] private benefits from power, e.g., bribes.
- Corollary: Liability to make amends (or step down) - no impunity.

Problems with Accountability

▶ *Implicit Assumptions*

- Fundamentally, different people's interests always diverge – each one unto oneself.
- By definition, there could be loyalty only to a single principal/beneficiary.

▶ *Typical Implementation Mode*

- Accountability-based corporate governance constantly strives to identify potential conflicts of interests – identify contradictions.
- It seeks to resolve conflicts by providing information and delegating power to [seemingly] non-conflicted parties: independent directors, disinterested shareholders, external auditors, the "market."

▶ *Implementation Problems*

- Multiple Objectives – Just as agents can't serve several masters, they have difficulties pursuing several competing tasks (Holmstrom & Milgrom; Dixit; Tirole).
- Soft Objectives – Lurking conflicts of interests and the need to account (especially financially) make it difficult to pursue soft, qualitative objectives – related to the problem of non-verifiability (Dixit).

Cultural and Psychological Features

▶ *Social Context*

- Accountability is a norm of ethics, grounded in social values (Dubnick).
- Accountability is sensitive to social context. People behave differently – they seem even to think differently – depending on whether and to whom they expect to be held accountable (Tetlock et al.).

▶ *Cultural Orientations*

- In the Schwartz model, accountability implies relatively high autonomy – a cultural view of people as autonomous beings. The constant emphasis on conflicts of interest highlights people's independence.
- Accountability recognizes hierarchy, but legitimizes its consequences only to some degree – subject to the awareness and consent of the "accountee". Accountability is not wholly egalitarian nor is it highly hierarchical; it is somewhere in between.

▶ *Social Axioms*

- In the Bond-Leung framework, accountability implies relatively low to moderate social cynicism – people can be trusted but must be guarded – fiduciary relations can exist but must be constantly checked.

▶ *Cognitive Style*

- In the Nisbett-Peng framework, accountability calls for clarity. "Dialectic loyalty" is an oxymoron, if not a plain breach of trust.

Incompatibility with Asian Culture

▶ *What is Culture?*

- In the North-Williamson framework, culture stands for informal institutions – the unwritten, unspoken rules of the game.
- Value preferences [psych] parallel motivations [econ].
- Social axioms [psych] parallel priors [econ].

▶ *North-East Asia vs. English-Speaking Countries*

- Accountability is compatible with the basic cultural profile of English-speaking countries – not entirely surprising.
- Confucian-influenced Asian countries (China, Korea, Hong Kong) are lower on autonomy, higher on hierarchy, and higher on social cynicism.
- People in this region are guided by a different set of motivational goals, work off a different set of prior beliefs, and process information in a different style.
- The OECD's "board accountability to the company" and directors' "duty of loyalty" in corporate laws can't trigger the same actions and expectations.
- Perhaps less able to identify conflicts of interest and delegate to externals; but, perhaps better able to handle multiple objectives and vague situations.

Adapting Accountability

▶ *"Adaptive" or "Against"?*

- Originally, this presentation was entitled "Against Accountability". "Adaptive Accountability" implies that there is hope.
- Both versions, however, reject "universal accountability."
- The discussion echoes a familiar debate in international regulation.

▶ *The Universalist Approach – "And Accountability for All"*

- Pro: We have a successful working model. And we probably can't wait for "organic" evolutionary adaptation.
- Con: It probably doesn't fit. Incompatibility of legal rules with the institutional environment will frustrate their intended results (Aoki).

▶ *The Adaptive Approach – "Confucian Corporate Governance"*

- What is this? We don't know for sure – not a clone of the US/UK model.
- Pro: It would fit.
- Con: We don't have a working model; Confucianism connotes obsolescence; no established criteria for assessment.
- At first glance, this looks like the road not taken. But perhaps this is what policy-makers in China and Korea have been doing.
- The region has the longest existing states – a tradition of governance.

Corporate Governance in Global Capital Markets

▶ *The Dominance of Anglo Preferences*

- Corporate governance as a social system must also adapt to open financial markets. Here, US/UK institutional investors rule.
- The present analysis may imply a best response strategy of catering to their culture: preferences, priors, etc.

▶ *Some Evidence*

- On the one hand, US/UK-inspired independent directors may have a (shareholder) value-enhancing effect in Korea (Black-Jang-Kim).
- On the other hand, informal cultural differences deter cross-border investment (Guiso-Sapienza-Zingales; Siegel-Licht-Schwartz).

▶ *Differential Reform?*

- The case for a culturally-compatible corporate governance model is stronger for smaller firms – SMEs, TVEs.
- However, even in giant public firms, people come from a culture (and investors know this).

Concluding Remarks

- ▶ All too often, culture is treated either romantically or opportunistically, to impede reform. Not very helpful for corporate governance analysis.
- ▶ Policy-making should not romanticize culture but also should not demonize it.
- ▶ The culture and psychology of a society are part of its human capital. Writing off this capital may not be easy and in some cases, may not be profitable.