Luigi Passamonti
Senior Advisor
The World Bank

Governance – Several fronts in several worlds
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Governance has been dominating the headlines since the breakdown in trust that has occurred following some high-profile corporate distress situations, mainly in the US but also in Europe. They have prompted the intervention of governments, parliaments, criminal prosecutors, financial regulators, organizations of accountants and auditors. It is a formidable mobilization of public attention, perhaps excessive, but certainly unprecedented for its breadth, reach and judicial clout. The functioning of the capitalist system has come under scrutiny.

An overview

But I would like to address governance issues in a broader sense -- beyond the corporate world.

Based on what I have been observing as part of my World Bank work, I will make considerations about governance as it affects many actors and functions: governments for their core functions and as they interface with the business community, the business community as it engages with governments and civil society, banks as well as individual corporations. I will show that your company has a stake in good governance being practiced at each of these levels, starting from the corporate level and ending at the government level. But also, because of a thread linking these levels, I will suggest that your company can influence and promote good governance at several levels – for your shareholders' benefit.

Throughout my intervention I will give the concept of governance an efficiency meaning that draws, mutatis mutandis, from this definition by Luigi Zingales: *"Corporate governance are the set of arrangements that maximize the incentives for value-enhancing investments while minimizing inefficient power seeking."*

Governance and Development

To start from the global level, I would like to read you a quote from the Development Committee Communiqué issued last month in Dubai. The Development Committee is the group of 24 ministers of finance and central bank governors that guide the activities of the International Monetary Fund and the World Bank with developing countries.

The Communiqué stated: *"Developing countries will have to sustain their efforts to strengthen policies and governance so as to ensure that domestic resources, private inflows and aid can be used effectively in spurring growth."*

This is a very important sentence. It says developing countries do not have an entitlement to receiving aid. They need to create the domestic conditions to make good use of any financing available – be it internal, external or aid. The issue is one of public sector governance.

Public sector governance

Weak public governance is now clearly seen at the heart of under-development. Corruption, arbitrariness, excessive government intervention and misguided resource allocation have slowed down growth and deterred business activity.

How can this be corrected? There is no external intervention that can prompt politicians, government officials and society at large to behave differently. All that the international community can do is to highlight the costs to local citizens of weak governance and corruption. And to those governments that have resolved to act on this scourge, the international community can be of help by providing "organizational" advice as a McKinsey or BCG would do in a corporate context.

The World Bank, for instance, frames its interventions in public sector reform around three drivers: first, "rules and restraints", second "competitive pressures" and third, "public accountability".

Designing and perhaps implementing good economic policies is difficult but not impossible. Fund and Bank can help governments improve their performance on monetary and exchange rate policies, public expenditure management, tax administration, civil service management, judicial reform.

Delivering efficient public services is certainly more challenging – especially when there is no competition.

But what is very hard is to create a sense of public accountability. Building on a combination of government internal processes (e.g., court of audits) and a proper separation of powers, this is achieved through involvement of free and informed media and civil society engagement. It is public accountability that helps fight corruption.

Government regulations of business activities

But an even more challenging activity is for governments (central and local) to regulate business activities efficiently and effectively. Proper governance entails, in this case, to define where the government role stops and where the private sector responsibility steps in. The Zingales efficiency definition helps frame this aspect of public sector governance.

In the World Bank's experience, the weaker the government, the more pervasive its regulatory involvement is. And the more pervasive its presence is, the bigger room it has for discretion, abuses, perhaps corruption and certainly creation of all sorts of competitive distortions. So an integral aspect of good public sector governance is the extent to which government is able to help – and not to hamper -- the business community do its job which is to grow sales and profits and create jobs.

I am happy to report that this issue has been receiving a lot of attention at the World Bank lately. We call it "investment climate". We could also call it "business environment". The sad reality is that it is much harder to build and manage businesses in developing countries than in developed countries. It takes more steps to register a company, it is more difficult to hire and to fire workers, it is more difficult to enforce commercial contracts and credit is less available. The regulatory burden, which takes the lethal combination of large number of procedural steps and weak enforcement capability, impacts productivity, breeds corruption, delays restructuring, increases unemployment, feeds the "black" economy. It works squarely against development.

How can a government best calibrate its business regulations? Liberal economists picture this decision as a trade-off between the cost to society of selfish corporate behavior and the cost of state intervention. Recently, there has been progress in assessing the latter in terms of foregone growth opportunities, employment creation and so on.

While the practical task of designing "growth-friendly" business regulations is never easy (and it depends on specific activities and country circumstances), there are two aspects in developing countries that can help move towards this goal. One, most regulations date back to the colonial period. The matter, thus, is one of reviewing them against current business practices. Second, governments have weak "feedback" loops on impact of regulations on economic activities. A more pro-active involvement of the business community is both possible and desirable to help design more business-friendly regulations.

Corporate social responsibility

This brings me to the third aspect of "governance" – both in the broad spirit of the Development Committee Communiqué, which makes it a pre-condition for growth, and the Zingales quote which puts emphasis on efficiency. It is the matter of corporate social responsibility. I noticed how prominently it featured in the Italcementi corporate profile that you have shared with me.

It springs from the recognition that, especially in countries with weak governments and weak government services, corporations can do a lot to mitigate their operating risks by having an explicit strategy to deal with the environment they operate in. And that attention paid to so called "sustainability" factors has a financial pay-off on business success factors. "Sustainability" factors are environment, local economic growth, community development, human resource development and, of course, responsible engagement with political and governmental authorities. The so-called "state capture", which occurs through corruption, is a major impediment to government effectiveness.

Corporate social responsibility activities relate to both public and corporate governance considerations. They draw, on one hand, on a recognition by the government that the effectiveness of its public action can be enhanced through a partnership with the private sector; and, on the other hand, on a similar recognition by a corporation that shareholder interests can be enhanced over the longer term through a partial extension of its activities into public policy areas where its financial and managerial contribution can help shape a better outcome.

There are two logics to it: a defensive one that argues that NGOs and other social actors can do a lot of harm to a company's reputation if it is perceived to conduct its business irrespective of its social and environmental consequences. But I believe the pro-active logic is much more powerful.

The only hope for a future with less poverty comes from responsible private sector activities – not from official aid. Kofi Annan said this last year at the Johannesburg Summit. There is a growing recognition that a slightly expanded "social" role of entrepreneurs makes them also a more credible government partner when it comes to designing economic policies and business regulations. Indeed, there is a convergence of interests between the business sector and government: the two are allies in improving the standards of living.

The World Bank is helping governments understand how they could interpret their role vis-à-vis the business community. We distinguish four modalities: the first is the classic "mandating" – government enacting laws. But then we are encouraging them to see their role as one of "facilitating", "partnering" and "endorsing". "Facilitating" means that they can issue non-binding incentives, guidance, codes to help good business practices. "Partnering" means they could combine their resources with those of the private sector to achieve economies of scale and cross-

fertilize best practices. "Endorsing" means they could give public recognition to good corporate actions.

Governance of financial institutions

I come to my fourth, and next to last, aspect of governance which is governance of financial institutions. What is so special about it? Not much has been said and written about governance failures of financial institutions. Allow me to go into some detail on this aspect. It has a strong impact on promoting growth, as I hope I will be able to illustrate it.

Financial stability is one of the most precious public goods. Monetary and financial authorities are the guardians of the integrity of the payment infrastructure and the ongoing ability of the financial sector to recycle savings into productive investments. Financial intermediation and banking in particular is an activity that is as carefully regulated and supervised as probably any one else in the economy – except perhaps nuclear power.

But banks are much more complex and opaque to monitor than a nuclear plant. Supervisors find it difficult to be ahead of financial innovations when monitoring bank activities. For some time they have recognized they need to work hand in hand with the market. Alan Greenspan said: "*We need to adopt policies that promote private counter-party supervision as the first line of defense for a safe and sound banking system*". However, regulatory and supervisory policies and practices tend to look mainly at how creditor actions can reduce banks' risk appetite. They leave the role shareholders and boards play quite undetermined.

In industrialized countries the importance of bank governance is obscured by the fact that the sophistication of bank supervision and the presence of deep counter-party markets can compensate for the lack of prominence of shareholder and board discipline. But increasing level of banking FDI in risky regions (Latin America as well as Eastern Europe) does pose the issue of how can home country supervisors help international banking groups monitor their cross-border risks if their local operations have weak governance structures.

In developing countries, financial depth is very low and bank supervisory capacity is very weak. There can be no sustained growth without supporting bank credit. It means that the financial sector has to underwrite more risks as the economy grows. Weak official and private oversight of banks (i.e., governance) has been very costly to developing countries and the international community at large. In the last twenty years, the cost of financial crises in the developing countries has been $1 trillion -- $1 trillion of fiscal resources that has been applied to reimburse depositors of failed financial institutions instead of being used to build infrastructure or better educational systems. This staggering amount is equal to the cumulative official aid flows. It is a considerable waste of public money. Hence, I believe, the matter of bank governance is truly central to the issue of growth in developing countries, and its financing – as indicated in the Development Committee Communiqué.

Corporate governance

Finally, I reach the end of my conversation touching on issues of corporate governance. I left it last because this is a topic which is certainly very well known to you all, as it affects your core activities. It relates to the continued ability of your group to raise funds in the public markets from all sorts of investors, giving them assurances that their money will be taken care of as if it were the money of the majority shareholder or the money of the management team.

Gordon Brown, the current Chairman (and a successor to Prof. Pandolfi) of the International Monetary and Financial Committee that oversees the macro surveillance and financial stability work of the IMF, said in Dubai: "*We agreed that the vigorous pursuit of structural reforms and enhanced corporate governance and transparency are key to stronger, globally balanced growth*".

What does enhanced corporate governance mean? Rather than discussing minute technical details, I find it more useful to think in terms of a conceptual framework -- which is the division of powers of the constitutional architecture. As much as a constitutional system underpins political democracy, so corporate governance must protect financial democracy.
How aligned are, in the corporate world, the activities of the executive, legislative and judiciary power to protect the interest of the citizen i.e., the investor?

My sense is that financial democracy, both practically and conceptually, has still to catch up with political democracy. Witness the uproar with which has been received the SEC rule that mutual funds disclose their voting decisions or the proposed rule, presently under discussion, that would enable shareholders to directly appoint a few board directors under quite restrictive conditions without prior board endorsement.

I would like to say that the ability of the business community to engage, as it should, with governments to design growth-friendly business regulations and to engage in social responsibility initiatives has to be grounded on having first its own house in order.

Conclusions

To wrap up, governance indeed impacts the business community and individual corporations from many fronts.

What is at stake, in a systemic sense, through proper government governance, is the possibility to give a future to the 5 of the 6 billion people that live in developing countries, 3 billion of which survive under $2 a day. A future for them means strong economic growth.

Government has to learn where to stop when regulating business activities. And it has to learn how to shape the interface of its activities with those of the business community when the latter decides to act in a social responsibility context. The dividend is stronger economic growth.

Proper governance of financial institutions with enhanced shareholder and board discipline is necessary both to avoid financial over-regulation and to help prevent financial crises which are costly and very disruptive to economic growth.

But all of this is predicated on sound corporate governance at the company level. This is the foundation of the whole edifice.

Your own corporate activities in so many developing countries, Egypt, Morocco, India, to name but a few, can make a systemic difference to the life of their citizens – and to the wealth of your shareholders.

Thank you very much.