MACROECONOMICS AND GOVERNANCE

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ABSTRACT

In recent years there has been a resurgence of interest in the impact of institutions on economic growth and development. Governance, both at the economy-wide and firm-specific level, has emerged as one of the central aspects of institutional structure and design.

The paper argues that the quality of governance matters to macroeconomic performance because it provides a key foundation for the equitable and efficient allocation of resources, including capital. Better governance tends to be associated with deeper economic and financial development, with the causation running from better governance to higher income rather than the other way round. Better governance also reduces the risk of macroeconomic instability, by containing the types of shocks to which an economy is exposed and by making it easier for private and official decision-makers to deal with negative shocks when they occur. This matters for all economies, be they developing, emerging, transition, or industrialised.

This paper sets out some definitions of governance, at both the economy-wide and firm-specific level, and explores what is meant by 'good governance'. It sets out some indicators of governance for selected Asia-Pacific economies. It explores some of the ways that governance can matter for macroeconomic growth, development and stability.

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1. INTRODUCTION

In recent years there has been a resurgence of interest in the impact of institutions on economic growth and development. Governance, both at the economy-wide and firm-specific level, has emerged as one of the central aspects of institutional structure and design.

The quality of governance matters to macroeconomic performance because it provides a key foundation for the equitable and efficient allocation of resources, including capital. Better governance tends to be associated with deeper economic and financial development, with the causation running from better governance to higher income rather than the other way round. Better governance also reduces the risk of macroeconomic instability, by containing the types of shocks to which an economy is exposed and by making it easier for private and official decision-makers to deal with negative shocks when they occur. This matters for all economies, be they developing, emerging, transition, or industrialised.

This paper is structured in the following way. Section 2 sets out some definitions of governance, at both the economy-wide and firm-specific level, and explores what is meant by 'good governance'. It sets out some indicators of governance for Manila Framework Group (MFG) and selected other East Asian economies.[1] Section 3 explores some of the ways that governance can matter for macroeconomic growth, development and stability. Section 4 highlights that governance is an ongoing issue in all economies, and draws three policy insights from recent failures of governance.

2. THE BASICS OF GOOD GOVERNANCE

Governance encompasses a wide range of institutional features. At its broadest level, governance refers to the basic institutional and market framework in which firms and official bodies operate. This includes the effectiveness of administration, the quality of regulatory systems, the rule of law, and the control of corruption. Table 1 provides some general indicators of 'good governance'.

Table 1: General Indicators of Good Governance

Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
bureaucratic quality	market friendly systems	incidence of crime	use of public power for private gain
competence of officials	adequate supervision	judicial ethics, effectiveness, and independence	
political independence	accounting standards	risk of expropriation by government	
		enforcement of government contracts	

Source: La Porta et al. (1998) and Kaufman and Kray (2002).

1 The MFG economies are Australia, Brunei, Canada, China, Hong Kong SAR, Indonesia, Japan, Malaysia, New Zealand, the Philippines, Singapore, South Korea, Thailand and the United States.

The prerequisites for 'good governance' are generally acknowledged to be well-functioning legal and regulatory frameworks, well-resourced and professional regulators and supervisors, clear and enforceable systems of corporate, contractual, insolvency and property law, and freedom from fraud, capricious action and corruption.

In recent years, there has been a surge in the assessment and measurement of 'governance'.[2] There is, of course, no single objective measure of governance, so analysts have tried to infer it from a wide range of indicators. This has proved controversial because many indicators are based on private surveys of firms and government officials and hence are subjective. But while they have limitations, the qualitative assessments are highly correlated with each other and tend to be consistent with country credit ratings.

Figures 1 and 2 present Kaufman and Kray's (2001) estimates of 'rule of law' and 'regulatory quality' respectively for 1997-98 and 2000-01 for MFG economies and selected other East Asian economies in a rising scale from — 2.5 to 2.5.[3] Figure 3 shows the movements over the past decade in

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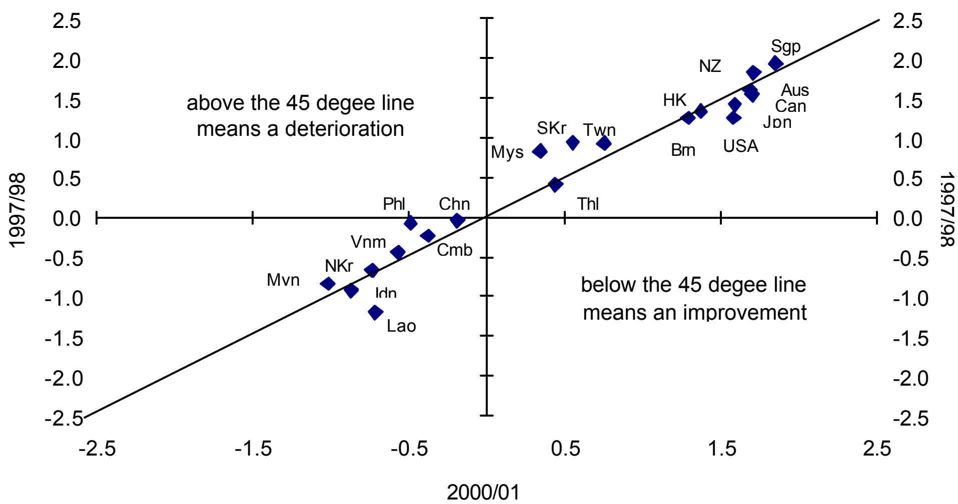
2 These include the groups of papers by La Porta, Lopez-de-Silanes, Shleifer and Vishny at Harvard University, and Kaufman, Kray, and Zoido-Lobaton at the World Bank. They approach governance largely from the perspective of economists. Other disciplines, particularly those with a focus on social development, include other aspects within their concept of governance, such as participation, responsiveness to the needs of the people, and equity.

3 'Rule of law' is based on a mix of surveys and component factors such as losses and costs of crimes, kidnapping of foreigners, enforceability of private and public contracts, corruption in banking, theft and crime, black market activity, property rights, tradition of law and order, confidence in public authority to secure property, and unpredictability of juries. 'Regulatory quality' includes indicators

Transparency International's estimate of corruption, another commonly used measure of governance. These are but one set of assessments, and using them does not necessarily imply endorsement of particular rankings. But there are two key points one could infer from these graphs.

Figure 1: 'Rule of Law', 1997/98 and 2000/01



Source: Kaufmann and Kray (2002)

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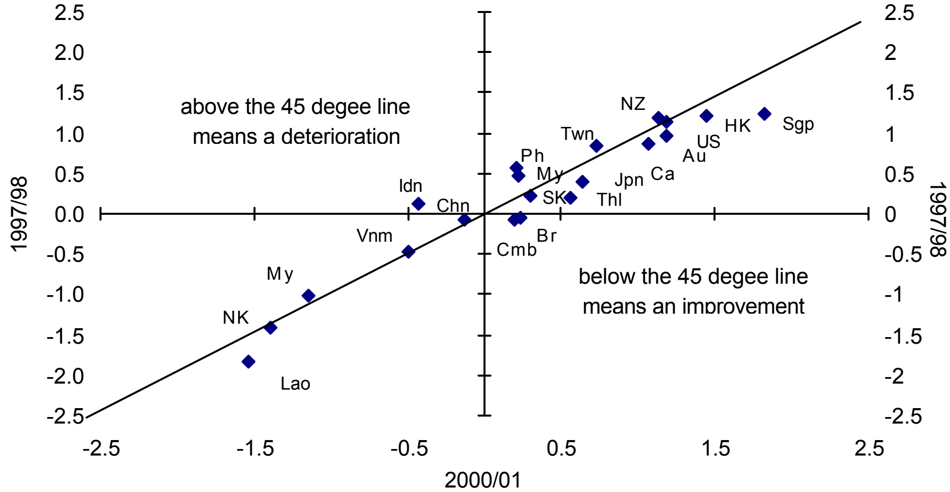
such as regulations on exports, imports, business operations and ownership, competition policy, price liberalisation, banking reform, bankruptcy law, extent and effectiveness of financial regulations, extent of administrative regulation, and perceptions about the tax system. These are drawn from the published estimates of enterprises such as Business Environment Risk Intelligence, the State Failure Task Force State Capacity Survey at Columbia University, Standard and Poor's DRI/McGraw-Hill assessments, European Bank for Reconstruction and Development, the Economist Intelligence Unit, Political Risk Services, and the World Economic Forum. These many individual measures are aggregated into a single measure by using unobserved components estimation techniques.

Figure 2: 'Regulatory Quality', 1997/98 and 2000/01

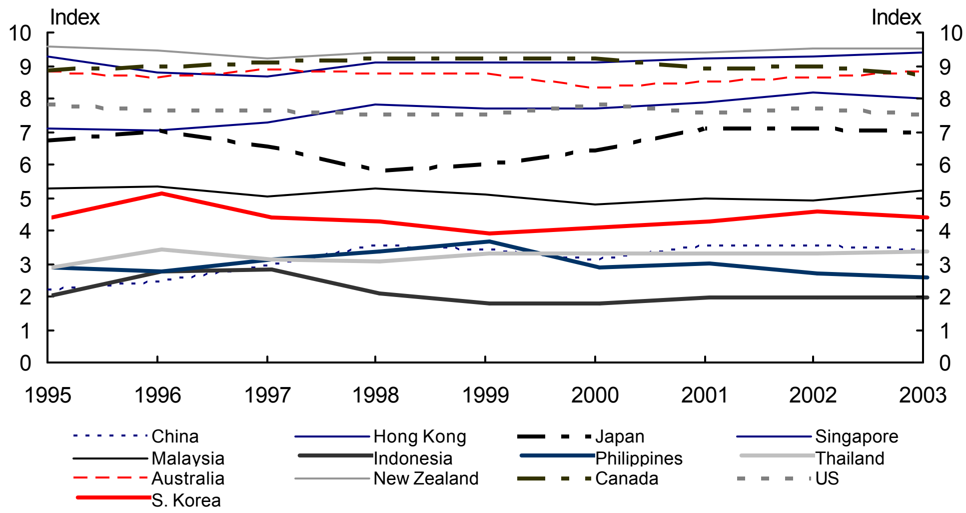


Source: Kaufmann and Kray (2002)

The first is that many of these economies are very different from each other. There is a lot of heterogeneity, with some economies clustered toward the bottom of the scale (the bottom left-hand side of the figure), some toward the top (the top right-hand side of the figure), and quite a few in between. No country has a perfect score. Countries tend to be clustered in the same way for different measures of governance.

The second point is that, while there are some changes, there has not generally been a lot of movement in these indicators of governance over the past five years. The persistence in governance indicators sits uncomfortably with the substantial reform agenda that has been enacted in the years after the East Asian financial crisis. There are two possible interpretations for this (either or both of which may be true). It may be that perceptions have not yet caught up with the reality of reform in some countries, perhaps because perceptions are themselves subjective and persistent. Or it may be that while the legal process has been reformed, changes embedded in the reform are still to be implemented (OECD 2003).

Figure 3: Corruption



Note: Higher numbers imply lower estimated corruption. Source: Transparency International

Governance is also an issue *within* firms. At its heart, corporate governance is concerned with aligning the interests and behaviour of managers with the interests of the owners of the firm. In firms with diffuse ownership, analysis of corporate governance focuses on facilitating the agency relationship between managers and owners. In firms with concentrated ownership, as is typical in East Asia (and parts of Europe), the analysis of corporate governance tends to focus on how to protect the rights of minority shareholders, ranging over issues like board independence and transparency. While shareholder rights and protection are the primary focus, corporate governance also extends to issues such as the rights of creditors (particularly in firm insolvency), the exercise of control over firms, the regulation of securities markets, and competition.[4]

4 See, for example, Maher and Andersson (1999), Cheung (2001), Capulong et al. (2002), and OECD (2003).

In terms of legal systems, some argue that common law systems yield better corporate governance than German-civil law and French-civil law systems.[5] But the US corporate governance scandals of the past few years suggest that all systems can be vulnerable. Institutional design and regulatory cooperation are not aimed at convergence on a single model of governance across countries but on maximising the effectiveness of domestic systems and facilitating cross-border commerce. The Financial Stability Forum (2002: 4) states the contemporary position well:

> Corporate governance regimes are embedded in the unique history, institutional heritage, and economic/cultural mores of each country. There are, however, high level common principles and objectives valid for all countries, eg board independence, audit independence, avoidance of conflict of interest, and accurate and truthful disclosure.'

In making this assessment, the FSF has drawn on the OECD principles for corporate governance, which are also widely discussed in East Asia.[6] Given that shareholdings in East Asia tend to be concentrated (by families in market economies and by government in transition economies), a key

5 See La Porta et al. (1998) for the most influential study. In the East Asian region, they classify Australia, Hong Kong SAR, Malaysia, New Zealand, Singapore and Thailand as following the common law tradition, China, Japan, South Korea and Taiwan Province of China as following the German civil-law tradition, and Indonesia and the Philippines as following the French civil-law tradition.

6 See OECD (2003).

vulnerability in corporate governance in the region is the protection of minority shareholders.[7]

Corporate governance and the more general governance structures discussed above are related. For example, firms in countries with weak legal systems also tend to have lower corporate governance rankings.[8] But what the firm does can matter. A firm in a country with weak legal, bureaucratic and judicial systems can improve its access to, and lower its cost of, capital by taking specific action to mark itself as a ‘good firm’ and reduce the information asymmetries faced by investors. For example, a firm can improve its own transparency by providing more detailed reports, disclosing board decisions, adopting international accounting standards itself, or by issuing shares in key world markets (like American Depository Receipts in the United States) to obtain credibility and provide better protection for investors. Countries with poor governance mechanisms and concentrated firm ownership can partially offset the effects of these factors by allowing or encouraging firms to use external financing, such as through the development of corporate bond markets. Some ratings agencies also provide an independent assessment of firms’ corporate governance ratings, including those in China.[9]

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7 See Gibson (1999) and Capulong et al. (2002).

8 See Stulz (1999) and Klapper and Love (2002).

9 The World Bank, for example, funded such a program with Standard and Poors; see http://www2.standardandpoors.com/NASApp/cs/ContentServer?pagename=sp/Page/HomePg. Visitors to the site have to register to access firm-specific information but it is available without charge. Apart from providing governance

As a final comment, 'good' governance does not mean that firms should not fail. In market economies, firms enter and exit. The risk and cost of failure helps discipline and focus private decision making. In this regard, the aim of improving corporate governance is to reduce the likelihood that exit occurs because of managerial failure, self-interest or corruption, and to minimise contagion and flow-on effects to other firms and the economy in general.

3. GOVERNANCE MATTERS TO GROWTH AND STABILITY

For those concerned with macroeconomic policy, governance matters for two reasons. First, better governance tends to be associated with deeper economic and financial development. Second, better governance tends to be associated with greater macroeconomic stability.

3.1 Governance and economic development and growth

Governance is a necessary precondition for all economies to achieve sustainable economic growth and development. Countries with better governance tend to have higher income levels. Figure 4 plots the 'rule of law' as at 2000-01, for example, against per capita GDP in purchasing power parity terms in 2002 for the economies examined above. Given that the various measures of governance are highly correlated, the relationship in Figure 4 also holds for other measures of governance.

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scores for individual firms, they also provide corporate governance reports and transparency and disclosure studies by country.

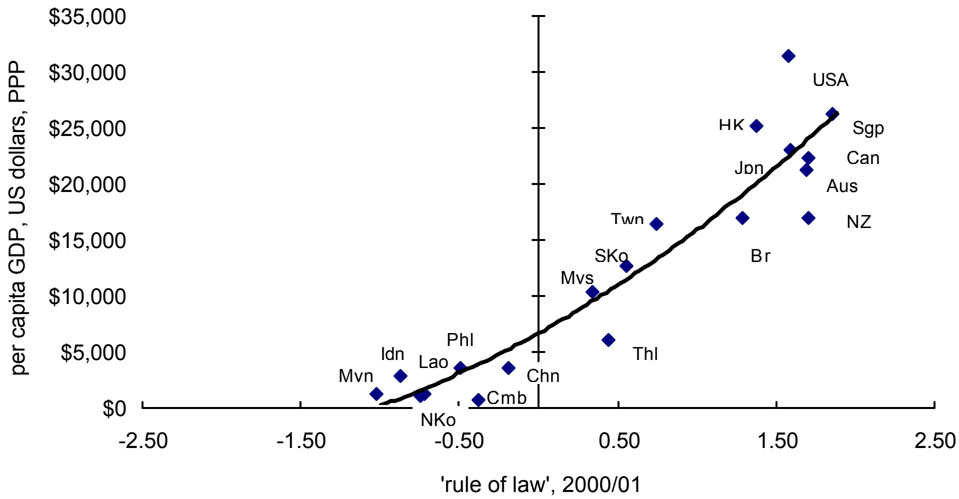
Governance can support economic development and growth in a number of ways. It provides the institutional foundation for the efficient allocation of resources, providing decision-makers with greater confidence about the commercial environment in which they operate. When institutions and markets function well, firms and households can get on with making well-informed decisions, the economy is better placed to deal flexibly with the adverse events and disturbances (‘shocks’) that inevitably occur, and there is less ‘rent-seeking behaviour’.[10]

The ‘numbers’ confirm this assessment. Recent studies show that per capita income is positively correlated with the quality and effectiveness of governance of the kind set out in Section 2.[11] They find that the positive causal effect runs from better governance to per capita income, not the other way round. These results are robust. The authors of these studies argue that countries cannot simply grow into good governance; indeed, as countries grow, unless the right governance processes are put in place, the economic gains will simply be appropriated by those with vested interests or power. Countries cannot just expect to grow out of weak institutions, rent-seeking, and corruption.

10 See Hall and Jones (1999) and Caballero and Hammour (2000) for detailed discussions on the importance of institutions in ensuring stable macroeconomic growth and development.

11 See Hall and Jones (1999) and Kaufman and Kray (2002). Mauro (1995) and Wei (2000) examine the effect of corruption on growth.

Figure 4: Governance and Economic Development



Source: Kaufman and Kray (2002)

The more a country gets its microeconomic and institutional structures right, the deeper and more stable is its macroeconomic development likely to be. This means better access to international finance, more developed equity and venture capital markets, and higher R&D, innovative activity and entrepreneurship.[12] Good governance can help foster financial development — by boosting stability in the banking sector, encouraging the development of liquid stock and corporate bond markets, and widening the institutional base to include collective investment vehicles like pension funds and mutual funds — which are important in providing diversified funding for entrepreneurial enterprises and markets and institutions to collect savings. The evidence also suggests that liberalising

12 See Maher and Andersson (1999). In emerging markets, private investment tends to rise once the stock market is liberalised (Henry 2000).

the capital account is more successful when effective governance mechanisms are in place.[13]

Governance is particularly important in enabling countries to attract foreign direct investment (FDI).[14] FDI is important to economic development and growth, not just because it funds an expansion of the capital stock and the production base of an economy, but because it transfers technology and skills which are less developed in the recipient economy. Recent work indicates that FDI has a bigger effect on investment and GDP growth than other forms of inflows, with a recent conservative estimate indicating that a 1 per cent of GDP rise in FDI boosts domestic investment growth by almost ¾ percentage point and GDP growth by almost ¼ percentage point.[15] In turn, the active presence of foreign firms in the form of FDI creates new pressures, and strengthens the domestic constituency, for reform and better governance.[16]

In recent years, the importance of good governance in supporting economic development has probably increased. According to a recent study of large foreign investors, the East Asian financial crisis, ongoing crises in Latin America, serious corporate governance problems in industrialised economies, lower global growth, and the focus on the ‘security agenda’ have combined to heighten investor sensitivity to

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13 See Areta, Eichengreen and Wyplosz (2001).

14 See McKinsey (2000), Cheung (2001), Gelos and Wei (2002), CMCG Working Group (2003), and Australian Treasury (2003).

15 See Razin (2003). See also Borenzstein et al. (1998), Bosworth and Collins (1999), Mody and Murshid (2002) and Department of Foreign Affairs and Trade (2003).

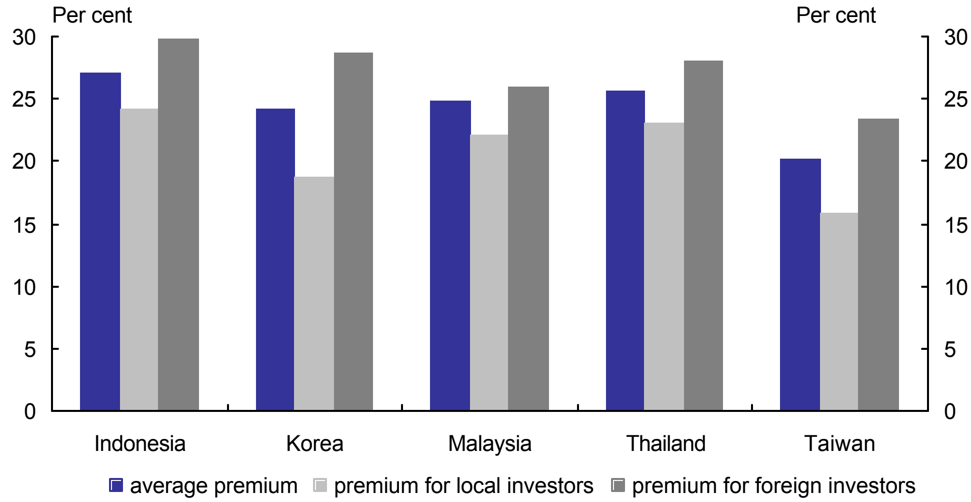
16 See Drysdale (2003).

country risk, and led to a greater centralisation of decision-making on foreign investment within firms.[17] Investors say that factors like political stability, low corruption, regulation (licensing regimes, tax regimes, and the attitude and quality of bureaucracy) and the legal framework (predictability of the operating environment, upholding contracts, and treating firms equally) are becoming more important. Investing firms are also trying to fund more of their investment in the FDI-recipient countries rather than from home-country sources or global financial markets.

Participants in that study see East Asia as one of the most competitive regions. In particular, China's accession to the WTO in 2001 is seen as a firm commitment to reform, marketise and internationalise its economy, which, in the context of sustained domestic economic growth and development, made that country the largest recipient of foreign investment in 2002. But the study sees two key challenges emerging. The first is for China to continue to improve its governance processes and to develop the stable domestic capital markets needed to fund FDI. The second is for similar markets — including those within the region and India – to remain competitive, attract foreign capital, and keep domestic capital.

17 See the CMCG Working Group (2003). The United Nations (2003) makes a similar assessment.

Figure 5: Premium on stock prices that investors say they are willing to pay for well-governed firms



Source: McKinsey (2000), Cheung (2001)

Investors want to invest in firms that are run well. A McKinsey survey in 2000, for example, indicated that around 89 per cent of investors are willing to pay a premium on the stock of well-governed firms. Figure 5 shows the McKinsey survey estimate of the premium that domestic and foreign investors are willing to pay on stocks that have good corporate governance for selected economies in East Asia. Investors are willing to pay an average 25 per cent premium for these firms. Foreign investors are willing to pay up to 10 per cent more than domestic investors.

Therefore, governance also matters at the firm level. There are several studies which link corporate performance to corporate governance. Companies with better governance tend to perform better, in the sense that they have a higher return on assets and higher market valuation, which makes it easier for them to fund their operations.[18] Companies with lower

18 See Klapper and Love (2002).

corporate governance standards tend to face higher capital costs and pay a greater premium on the securities they issue.[19] Countries which require higher corporate transparency tend to have a lower country risk premium, a lower cost of capital, and higher trading volume and liquidity in their financial markets.[20]

Concentrated ownership within firms can also be damaging to economic development when it leads to the exploitation of minority shareholders by powerful owners diverting profits to themselves. For example, studies which look at Europe (where there is substantial concentration and sometimes weak enforcement of shareholder rights) find a premium of up to 80 per cent on voting over non-voting shares. The Asian experience is similar.[21] For example, one study has shown that related-party transactions of Hong Kong listed firms are extensive, increase with ownership concentration, and significantly destroy shareholder value at the expense of minority shareholders.[22] If this is true for Hong Kong, which has one of the stronger governance structures in the region, then it is also likely to be the case elsewhere.

3.2 Governance and economic stability

Governance matters to economic stability. Well-governed institutions and markets reduce the risk of economic instability and the vulnerability of the economy in two ways.

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19 See Gompers, Ishii and Metrisk (2001).
20 See Bhattacharya et al. (2003).
21 See Maher and Andersson (1999), Cheung (2001) and Cheung et al. (2003).
22 See Cheung et al. (2003).

First, good governance helps contain the types of shocks to which an economy is exposed. The weaker are corporate and general governance, the more likely is an economy to be exposed to firm-specific shocks and disturbances. The more extensive is corporate misbehaviour, the more vulnerable are corporate balance sheets, and the more exposed is economic growth and employment to shocks.

The problems in US corporate governance are a case in point. The series of major accounting and reporting scandals that emerged throughout 2001, 2002 and 2003 undermined investor confidence in US corporations, putting downward pressure on share prices, consumption and investment.[23] Using the Fed's FRB/US model, the Brookings Institution estimated that the problems in US corporate governance from December 2001 to July 2002 alone directly cost the US economy between 0.2 and 0.5 per cent of GDP (US$20-50 billion) in the year, with a base-case estimate of 0.34 per cent of GDP or US$35 billion, equivalent to the first-year output loss due to a $10 rise in oil prices.[24]

The total effect of this poor corporate governance is probably larger and broader than this, because the above estimates do not include international

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23 The major US accounting scandals included Enron (October-December 2001), Global Crossing (January 2002), K-Mart and Tyco International (January 2002), Adelphia Communications (March 2002), Xerox (April 2002), Imclone Systems and Martha Stewart (June 2002), WorldCom (June 2002), Merck (July 2002), Qwest Communications (July 2002), and Bristol-Myers Squibb (July 2002). Problems in the governance of mutual funds also emerged in late 2003; see The Economist November 8-14, 2003 for a review.

24 See Graham, Litan and Sukhtankar (2002).

effects and feedback, and the way these scandals undermined perceptions about market-based economics as a whole.

Consider, too, the impact on firms of the East Asian financial crisis. The stock prices of firms in crisis-affected countries generally did not fall as much when they had better corporate governance, as measured by higher level of disclosure (for example, whether they issued ADRs or had one of the big-6 firms as auditor) and more outside share ownership.[25] The upshot is that even at the micro level, firms which are well-governed are better placed to deal with adverse events. Countries that fared better in the crises, like Malaysia and South Korea, also had relatively more effective corporate governance arrangements.[26]

Second, good governance makes it easier for firms and households to deal with negative shocks when they occur. Despite suffering big negative external shocks in the East Asian financial crisis, for example, Singapore and Australia fared relatively well, in part because their companies, banks, public institutions, and domestic economies were in good shape.

The threshold for weaknesses in governance to harm macroeconomic stability are probably not constant over time. The macroeconomic consequences of weak governance most likely depend on the stage of the business cycle and on the reaction of key institutions, including the political system. Box 1 sets out three recent examples.

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25 See Milton (2002) and Claessons et al. (2000). This is not to say that there are not problems with the large accounting firms.

26 See Johnson et al. (2000).

Box 1: Factors Compounding the Effect of Weak Governance

The macroeconomic consequences of weak governance probably depend on the business cycle and effectiveness of key institutions. Consider three examples:

- The negative impact of the US accounting scandals on the US stock market and macroeconomy was compounded by the collapse of the US tech bubble and the associated under-investment that took place as firms sought to repair their balance sheets.

- The current SK group scandal in South Korea occurred at a time of weakness in the global economy, sluggish consumption as households used income to wind back their debt, rising security concerns about North Korea, and more-than-usual political uncertainty. Because it occurred at a time of relative macroeconomic weakness, the negative effect of the SK scandal on domestic investment was probably bigger than it would otherwise have been.

- The macroeconomic impact of weaknesses in governance may also be compounded by difficulties in the political system to address these weaknesses. Heightened political uncertainty in Indonesia in late 1997/early 1998 exacerbated the macroeconomic consequences of the failures of governance exposed in mid 1997.

While the by-now voluminous 'growth literature' indicates that opening the economy is important in securing economic growth, openness also exposes the economy to new external disturbances. This raises the importance of sound domestic institutions and effective governance. As countries privatise firms under public ownership, they should aim to do so in a way which maximises the social gains from that process.

But this is not just a matter for developing or small and mid-sized economies. Given their prime place in the world economy, it is essential that the major industrialised nations also maintain strong and effective governance mechanisms to ensure global economic stability. Problems in the Japanese banking system in 1998, for example, caused a sharp repatriation of funds from the region and exacerbated the negative effects of the financial crisis. Similarly, the recent US corporate governance scandals in firms, accounting companies, and financial institutions have slowed the US economy and hence demand in the rest of the world.

4. GOVERNANCE IS AN ONGOING ISSUE IN ALL ECONOMIES

Governance is an ongoing issue for all economies. Private and official decision-makers in all economies face a continual challenge in facilitating good governance in private and public institutions. The collapse in 2002 of a major insurance company (HIH) in Australia, the accounting and mutual fund scandals in 2002 and 2003 in the United States, and the SK bribe scandal in 2003 in South Korea — to name just three instances — indicate that OECD governments, just as much as those in emerging economies, need to be vigilant in enforcing governance.

When the economy is growing strongly and asset prices are rising, the risk of asset price bubbles and excessive debt build-up also rises, leaving balance sheets vulnerable and growth and jobs more exposed to adverse shocks. Indeed, the weakness in governance and the build up of corporate malfeasance in the United States can be seen as the outcome of complacency based on an extended period of economic growth and protracted asset price rises. The extent of governance failures in industrialised economies indicates that weaknesses in governance may emerge periodically in an economy, much the same way as waves of asset price bubbles occur even in well-functioning financial markets.[27]

But that is not the end of it. There are perhaps three constructive reflections to take from recent experience in the failures of governance.

First, there are tremendous opportunities to learn from these problems about what sort of institutional design works to secure effective governance in a particular country. All countries have their own experience with governance failure. Many are able to respond and learn from this in a way suited to local practice and market conditions.

Firms also reform themselves. In Australia in the late 1980s, the largely unsupervised foreign exchange dealing area of AWA, a large manufacturing firm, effectively lost all the firm's capital in huge dealing losses. That company disappeared but the event led to a radical restructuring of foreign exchange and treasury operations in Australian

27 See Devenow and Welch (1996) for a review of models of herding in financial markets. Their assessment is that herding is a first-order phenomenon in financial

companies, with better internal control and reporting processes put in place. It is still in the minds of corporate treasurers and boards today. It also puts responsibility for governance back on decision-makers in firms.

Second, these failures can represent an opportunity to generate political interest in, and public support for, reform. It is important to pursue deficiencies in governance as they arise, and a crisis may represent an opportunity to advance reform. Governments have a responsibility in this area, and political action is required, especially if the regulators/supervisors are not sufficiently strong or resourced to enforce their mandate. Open discussion of these issues in the media can be a useful vehicle in generating wider support for reform. This helps counter the attack against reform by the vested interests which lose from reform.

But there are two difficulties that can emerge in attracting political interest. One is that the political process may be too slow in responding to the problems of governance. A drawn-out political response can create its own uncertainties and exacerbate the damage to expectations, investment and economic growth. While the corporate governance problems in 2002 and 2003 in the United States were serious, they were not compounded by political inaction and vacillation.[28]

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markets.

28 Regulatory competition between different supervisory agencies and different jurisdictions (notably the Federal Government and the New York State Government) in the United States may, in this case, have hastened political action to deal with the problems exposed by corporate scandals.

The other difficulty is maintaining balance in the political response to corporate failure and misdoing. Corporate failure is a fact of life in market economies. The danger is that public policy may over-react to the problems exposed and over-regulate firms — dampening the entrepreneurial and innovative behaviour which is at the heart of successful market economies — and creating new problems in regulation.

In its reflections on the recent US corporate scandals, the Financial Stability Forum (2002: 1) notes that the 'overall story it tells is one of inadequate standards in corporate governance, accounting, audit and disclosure, defective practices in these areas, in part as a result of weak enforcement of existing standards'. But it observes that the events themselves lead to market self-corrections, with some firms 'fessing up' to their own mistakes of the past and putting new processes in place to improve transparency and accountability — like voluntarily committing to review and disclose off-balance sheet entities and transactions, deducting equity-based remuneration schemes as costs in their income statement, increasing the separation between auditing and consulting services provided by accounting firms, and publishing codes of corporate ethics. The public response in this case, argues the FSF, is not to overreact and over-legislate but to support market self-correction by setting out clear public standards for audit quality, disclosure standards, and conflicts of interest.

When the political focus is elsewhere, officials can still help support good governance by taking a range of practical steps in general and firm-level governance: establishing 'one-stop shops' for interaction with government agencies, including for foreign investors; setting time limits for bureaucratic procedures and requiring reasons for rejection of applications; reducing official discretion in customs and tax administration; allowing/requiring electronic lodgement of documents and implementing automatic approval processes where appropriate; improving public service remuneration; and putting laws, regulations, tax regimes, procedures and corporate information on the web in the local language and in English.

Third, it is good to 'aim high' but countries should not expect to deal with every aspect of governance all at once. In particular, for those countries which are still in the process of opening up or privatising and marketising their economies, it is not feasible to expect to have all elements of governance and institutional reform in place before liberalisation and privatisation. No one gets it right all the time. Misbehaviour occurs. It is not realistic to wait for the perfect system.

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