International Journal of Corporate Law and Governance
Volume 1 Issue 1, 2026

Emerging Economies' Corporate Governance Challenges

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Article Info
Received: 22-01-2026 Revised: 02-02-2026 Accepted: 08-03-2026 Published: 18-03-2026

Abstract
In recent years, there has been a growing focus on corporate governance studies in developing economies. Despite the global focus on governance changes and the increased activity of governments, shareholders, and other business stakeholders, corporate scandals and managerial failures persist. Scholars and professionals are starting to recognise that national business systems have firm-level governance processes that are impacted by political, social, and legal macro-institutions. In collaboration with Corporate Governance: An International Review (CGIR), we arranged a special issue conference on the topic of "Challenges in Corporate Governance in Emerging Economies" in Edinburgh, UK, from December 4-5, 2015, to further research on governance issues in emerging markets. The characteristics of corporate governance in developing nations are introduced, the articles in the special issue are reviewed, and future study prospects are discussed.

Keywords: CEO turnover, corruption, corporate governance, crash risk, developing markets, institutional transformation, remuneration for managers, and issues with principal-principal agencies.

Introduction

In recent years, there has been a growing interest in corporate governance research concerning emerging economies (Al-Malkawi, Pillai & Bhatti, 2014; Allen, 2005; Berglöf & Claessens, 2006; Black, Gledson de Carvalho, Khanna, Kim & Yurtoglu, 2014; Claessens & Fan, 2002; Claessens & Yortuglu, 2013; Crittenden & Crittenden, 2012; Fan, Wei & Xu, 2011). The nature of governance issues and the firm-level governance mechanisms at work in various nations are being recognised by academics and practitioners as being influenced by political, social, and legal macro-institutions and embedded in their own national business systems (e.g., Aguilera, Filatotchev, Gospel & Jackson, 2008; Filatotchev, Jackson & Nakajima, 2013; Peng, Wang & Jiang, 2008). More precisely, distributed ownership, modest management shareholdings, the predominance of stand-alone businesses, and market-based transactions are often the causes of governance issues in industrialised countries. On the other hand, corporate group domination, pyramidal ownership structures, concentrated ownership, and high amounts of related-party transactions are characteristics of rising economies. Principal-principal disputes are thus a significant issue for business governance in developing nations (Young, Peng, Ahlstrom, Bruton & Jiang, 2008). Furthermore, weaker formal institutions and various informal institutions are common in emerging markets; these national institutions typically have a significant impact on the efficacy of corporate governance arrangements (Hou, Kuo & Lee, 2014; Kumar & Zattoni, 2013 and 2016).

The University of Edinburgh Business School organised a special issue conference on "Challenges in Corporate Governance in Emerging Economies" in conjunction with Corporate Governance: An International Review on December 4-5, 2015 in Edinburgh, UK, to build on the success of the special issue on "Asian Corporate Governance" (Li & Nair, 2009) and to further advance understanding of the pertinent issues. David Yermack of NYU

Stern School of Business gave the conference's keynote address. He was examined the implications of blockchain technology for corporate governance in developing nations, including more transparency and liquidity, lower trading and voting expenses, and less audits and legal requirements. About 70 proposals from academics worldwide and from a variety of fields were received for the conference and special issue. A total of twelve papers were chosen to be presented at the conference. Every manuscript underwent Corporate Governance: An International Review's usual editing and refereeing procedures. The four papers that were ultimately approved for inclusion in the special issue are reviewed in this piece, which also introduces the idiosyncrasies of corporate governance in developing nations.

Peculiarities of Corporate Governance in Emerging Economies

Different Governance Environments

Firm-level governance solutions that seek to reduce the costs of governance-related efficiency losses are likely to vary across developed and developing countries due to the disparities in the types and severity of governance issues that we find (e.g., Zattoni & Judge, 2012). Governance solutions often consist of an ideal combination of internal and external processes, with different weights for established and growing economies (e.g., Walsh & Seward, 1990). Relationship-based systems in emerging economies place more emphasis on the governance role of lending institutions, large blockholders, including family shareholders, and organisational governance hierarchies than do "bundles" of governance mechanisms in developed economies, which rely more on board monitoring, executive compensation, and the market for corporate control. Furthermore, state agencies play a major role in managing companies in major emerging economies like China, India, and Russia, even when some of their shares are listed on stock exchanges (e.g., Firth, Fung & Rui, 2006; Grosman, Okhmatovskiy & Wright, 2016; Yang, Chi & Young, 2011).

The evolution of firm-level governance systems and their efficacy are significantly impacted by changes in the economic environment as well as cultural, political, and legal institutions, according to governance trends in both developed and developing countries. Every nation's national government structure is often path-dependent (Bebchuk & Roe, 1999). One significant consequence of this path-dependency is that, while regulators and corporate governance advocates encourage the adoption of global best practices, formal and informal institutional differences interact with firm-level governance developments to provide a foundation for multifaceted, multi-level corporate governance systems that take into account the evolution of their nation-specific institutions. This is especially true in emerging economies.

Research Perspectives

In recent years, a considerable literature has begun to emerge that has challenged the objective of modern corporations itself. Specifically, this literature asks whether governance systems of modern corporations should be focused on maximizing financial returns for the shareholders and stakeholders (including customers, suppliers, employees, community) or should also cover the objectives of society at large, including protecting the environment (Freeman, Wicks & Parmar, 2004; Jones & Felps, 2013; Mitchell, Weaver, Agle, Bailey & Carlson, 2016). Falling under the rubric of ‘corporate social responsibility’ (CSR), and popularly referred to as the ‘environmental, social and governance’ (ESG) framework, this view signifies a whole gamut of corporate behaviour, ranging from falling moral standards and ethical practices in business to improving the quality of life of the workforce, protecting human rights, promoting gender diversity, caring for the environment, and meeting broader developmental goals such as alleviation of poverty and inequality (e.g., Campbell, 2007; Carroll, 1999; McWilliams & Siegel, 2001). Notwithstanding the concern by some that CSR might distort managerial incentives due to the presence of multiple objectives and exacerbate governance problems (e.g., Jensen, 2002), there is a growing assertion that socially responsible management that balances the legitimate stakes of internal and external constituencies (Talaulicar, 2010) can lead to higher financial return. This argument makes moot the trade-offs between shareholder objectives and social responsibility and suggests that growth that is sustainable in the long run may be achievable, although the underlying mechanisms driving this relationship may be more complex (Saeidi, Sofian, Saeidi, Saeidi & Saaeidi, 2015; Wang & Choi, 2013; Zhao & Murrell, 2016). CSR has become an important topic in countries across the world but has gained special emphasis in emerging economies because of the complementary role corporations can play in overall development processes to provide collective goods (e.g., Boddewyn & Doh, 2011) and to build institutions (Marquis & Raynard, 2015). The adoption of CSR practices whose effectiveness may also rest on institutional conditions (e.g., Halkos & Skouloudis, 2016) may therefore signal to investors the superior capabilities of firms that can be utilized to fill institutional voids common in developing countries (Su, Peng, Tan & Cheung, 2016; Jayasinghe, 2016).

The nature of the governance problem and the solutions that are characteristic of emerging economies, outlined above, have implications for empirical research. First, given the dominance of inside ownership and controlling shareholders, the study of ownership structure and its evolution remains an important area of research with respect to emerging economies as the effects of various ownership structures, and their interactions with the institutional environment, tend to differ across countries (Aguilera, Talaulicar, Chung, Jimenez & Goel, 2015). Extant literature suggests that concentrated ownership emerges due to effort by owners to protect their capital in the presence of weak legal and financial institutions (Boubakri, Cosset & Guedhami, 2005; Cuomo, Zattoni & Valentini, 2013; Gomes, 2000; La Porta, Lopez-de-Silanes & Shleifer, 1999). This in turn has effects on the market for corporate control and economic efficiency (Claessens, Djankov, Fan & Lang, 2002). As new institutions develop and existing institutions strengthen, one ought to observe dynamic changes in ownership holdings of corporations in emerging economies, leading to higher activity in the market for corporate control and consequent increases in firm performance.

Second, given the prevalence of business groups and pyramidal structures, and the presence of controlling owners in key management positions, related-party transactions will continue to remain an interesting area of research in the context of emerging market economies. One strand of literature tends to suggest that related-party transactions may lead to economic efficiency due to vertical integration and missing capital markets, particularly within business groups that may provide coinsurance against difficulties or distress faced by member firms (Gordon, Henry & Palia, 2004; Jia, Shi & Wang, 2013; McCahery & Vermeulen, 2005). The contrasting view is that related-party transactions with group companies could be ways of tunnelling resources from companies with low ownership rights to high ownership rights, while related-party transactions with controlling shareholders could be ways of serving the interests of majority inside shareholders at the expense of outside minority shareholders (Aslan & Kumar, 2014; Bertrand, Mehta & Mulainathan, 2002; Boateng & Huang, 2017; Healy & Whalen, 1999; Kang, Lee, Lee & Park, 2014). Empirical research in this area ought to distinguish between the different types and forms of related-party transactions, detect expropriating behaviour, and suggest ways of mitigating them.Third, with respect to solutions of governance problems, the role played by the board of directors (Abdullah, Ismail & Nachum, 2016), the audit committee (Khan, Muttakin & Siddiqui, 2013) and the outside auditor (Fan & Wong, 2005) remain a focus of empirical investigation for emerging economies.

may turn out to be less effective in emerging market environments (Chen, Li & Shapiro, 2011). In this respect, the role and composition of the nomination committee require more attention than has been accorded in the existing literature. Relatedly, board and committee behaviour and engagement in strategic issues deserve more attention compared to structure and composition (Judge & Talaulicar, 2017). Another important issue for achieving good governance in emerging economies is the quality of enforcement (e.g., Dharmapala & Khanna, 2013). A large body of work has documented that while the laws in the book in many emerging economies are comparable to those in many developed economies; the law on the ground is considerably weaker and is plagued by lower quality of implementation, detection and deterrence (Berglöf & Claessens, 2006; Coffee, 2007; Klapper & Love, 2004). In this connection, the role and effectiveness of both public enforcement through legal institutions as well as private enforcement through institutional activism and investor awareness (Berglöf & Claessens, 2006; Chung & Talaulicar, 2010; Jackson & Roe, 2006) constitute important areas of research in emerging economies.

Fourth, the concept of "governance bundles" (e.g., Schiehll, Ahmadjian & Filatotchev, 2014) as solutions to governance problems imply that empirical work on measurement of governance effectiveness must incorporate a combination of governance mechanisms, internal and external, rather than concentrate on any particular mechanism (Bosse, 2009; García-Castro, Aguilera & Ariño, 2013; Millar, 2014). Put differently, the measurement of effectiveness of any particular governance mechanism must take into account the juxtaposition of other complementary and substitute mechanisms without which one risks the problem of incomplete specifications and omitted-variable bias in empirical analysis (cf. Misangyi & Acharya, 2014). A promising development in this area of research is the evolution of the concept of a corporate governance index (e.g., Al-Malkawi, Pillai & Bhatti, 2014; Black, Gledson de Carvalho & Sampaio, 2014; Prommin, Jumreornvong, Jiraporn & Tong, 2016). Notwithstanding the challenges inherent in the creation of an aggregative measure (Black, Love & Rachinsky, 2006), the concept of a corporate governance index may provide an intuitive way of measuring the efficacy of various governance arrangements, where the same governance score can be achieved through a combination of internal and external governance mechanisms.

Fifth, there is the intriguing question of whether the path-dependent national governance systems that one observes in various countries around the world are equally efficient in terms of reaching the same governance outcomes, or whether some governance structures are intrinsically more efficient, with institutional rigidities and path-dependency preventing some national governance systems from reaching an efficient structure (cf. Yoshikawa, Zhu & Wang, 2014). This question arises when one extrapolates the concept of an optimal governance bundle from the corporate level. The subject of formal vs functional convergence (Gilson, 2001) necessitates a comparative analysis of the development of legal, financial, and political institutions as well as the relative performance of companies across national borders (e.g., Khanna, Kogan & Palepu, 2006).

Finally, the role of corporate social responsibility (CSR) will emerge as an important area of research in corporate governance in the coming years. CSR is still not well understood in developing countries, and deserves more scholarly attention (Wang, Tong, Takeuchi & George, 2016). There is heightened discourse in this area, with most countries making reporting of CSR expenditure mandatory for all listed firms, and with India and China going even further: India by enacting legislation to make CSR expenditure (of two per cent of net profits) mandatory for all listed companies (based on a mechanism of comply-or-explain) and China by requiring state-owned listed companies to undertake CSR expenditure as a part of their contract with the state. to diversion of funds from core activities. This research will also benefit from incorporating the institutional environment in which corporate governance and CSR activities are embedded and unfold their effects (Filatotchev & Nakajima, 2014).

Methodological Considerations

In order to guarantee better construct validity of data and to better address causality and potential endogeneity issues, which may be especially significant in the case of emerging economies, empirical research on corporate governance challenges in emerging economies may also benefit from more rigorous implementation of methodological approaches (Black, Gledson de Carvalho, Khanna, Kim & Yurtoglu, 2014).

In corporate governance research, identification methodologies for creating reliable casual inference have received more attention. Propensity score matching (PSM), fixed effects, difference-in-differences, event study, instrumental variables, the Heckman selection model, and regression discontinuity are common major techniques. According to Shipman, Swanquist, and Whited (2017), studies often exaggerate PSM's capabilities and omit crucial design decisions, indicating a general misperception of the econometric problems that PSM resolves. For instance, PSM handles endogeneity issues pertaining to functional form misspecifications, but it ignores the majority of endogeneity issues pertaining to self-selection or missing variables. Shipman et al. provide recommendations for more persuasive PSM applications, such as combining PSM with multivariate regression.

Bowen, Frésard and Taillard (2016) show that identification articles attract 22% more citations than matched nonidentification articles, and point to a secular rise in identification technology in the field of corporate finance and governance. Atanasov and Black (2016) indicate that shocks (i.e., natural experiments or quasi-experiments) provide a stronger basis for causal inference, and shock-based papers on corporate governance have roughly twice as many downloads per paper as non-shock based papers on Social Science Research Network. Regulatory changes on corporate governance rules in emerging countries provide useful shocks that can be used as identification strategies. Atanasov and Black (2016) provide guidance on how to improve shock-based causal inference, even if inference remains imperfect. In using shock-based instrumental variables, for example, the covariate balance between treatment group and control group needs to be shown.

To resume, quantitative studies need to carefully choose suitable research designs based on the nature of any potential endogeneity concerns. Of course, possible endogeneity is only one type of challenge in empirical research, albeit one that has attracted increasing attention. In the area of corporate governance, there are also many questions about which qualitative methods will continue to yield insights (McNulty, Zattoni & Douglas, 2013). More specifically, qualitative research methods may provide much potential to better illuminate the determinants, patterns and consequences of the aforementioned peculiarities of corporate governance in emerging economies.

Research Contributions in the Special Issue

The goal of this special edition of Corporate Governance: An International Review is to showcase excellent research on the governance problems and solutions typical of rising nations, as previously mentioned. The four articles in this issue cover a variety of governance environments (in both single- and multi-country settings), address different facets of governance issues in emerging markets, and draw from a variety of disciplines involved in corporate governance research.

In the first article entitled “An institutional perspective on corruption in transition economies”, Alon and Hageman (in this issue) analyse the level of unofficial payments for tax purposes in 21 transition economies of the former Soviet bloc. They document a negative relation between unofficial payments and rule-based trust measured by rule of law, but a positive relation with dispositional trust, which facilitates the exchange in resources. Since legal institutions are not well developed in Soviet bloc countries, informal institutions (such as trust-based informal networks) play an important role. In these countries, businesses are put in a position where bribes are expected in order to receive services and speed up bureaucratic procedures. The discussion is in line with the findings in Mironov (2015) that corrupt managers in Russia advance shareholder interests through avoiding paying taxes, obtaining government contracts, removing business impediments by paying bribes, and manoeuvring around bad laws.

CEO turnover and CEO compensation are frequently addressed subjects of corporate governance that have been widely studied in the context of emerging economies (Chen, Cumming, Hou & Lee, 2016; Conyon & He, 2014; González, Guzmán, Pombo & Trujillo, 2015; Hoskisson, Johnson, Tihanyi & White, 2005; Pessarossi, P., & Weill, L. 2013; as well as Chizema, Liu, Lu & Gao, 2015; Gallego & Larrain, 2012; Ghosh, 2006; Peng, Sun & Matkóczy, 2015). Prior research has mainly scrutinized the determinants of CEO turnover (e.g., Aivazian, Ge & Qiu, 2005; Cao, Pan, Qian & Tian, 2017; Fan, Lau & Young, 2007; Tsai, Kuo & Hung, 2009) as well as the performance effects and sensitivity of various arrangements of CEO compensation (Conyon & He, 2012; Firth, Fung & Rui, 2006; Mengistae & Xu, 2004).

He, Shaw and Fang (in this issue) analyse the relationship between CEO compensation and voluntary CEO turnover. To better illuminate this complex relationship, they consider important institutional moderators, namely labour-market transparency, mobility and competitiveness, and show how these contingencies shape the supply and demand conditions of the managerial labour market. Based on institutional theory, organizational psychology (most notably equity theory) and labour economics, their article indicates how the institutional environment and labour market characteristics tend to link pull-side and push-side drivers of CEO turnover within an emerging economy.

As previously stated, the purpose of this special edition of Corporate Governance: An International Review is to highlight outstanding research on the governance issues and solutions common to developing countries. The four papers in this issue draw from a range of disciplines engaged in corporate governance research, explore various aspects of governance concerns in developing markets, and cover a diversity of governance contexts (in both single-country and multi-country settings).

Sun, Yuan, Cao and Wang (in this issue) study the impact of reform of the split-share structure in China on the risk of a stock-price crash. The reform terminated the trading constraints on restricted shares of listed firms in China, which were largely held by state shareholders. It aligns the interests between dominant state shareholders and private minority shareholders, which in turn decreases their conflict of interest with private minority shareholders, and reduces the risk of a stock-price crash. The findings add to studies of this arguably most significant leap in the Chinese capital market, which has been found to increase stock informativeness (Hou, Kuo & Lee 2012), turnover-to-performance sensitivity (Chen, Cumming, Hou & Lee, 2016), and both output and profit (Liao, Liu & Wang, 2014).

In the fourth paper entitled “Buying gold at the price of silver? Controlling shareholders and real estate transactions in Korean listed firms”, Yang (in this issue) studies controlling shareholders in Korea. Many firms are controlled by families but not wholly owned by them: the rights to cash flows from the firm are less, often much less, than the rights to control the firm. This structure gives the controlling shareholder an incentive, and the power, to direct their firm to conduct transactions whereby the firm loses and the shareholder or their family interests gain. Since the loss to the firm is shared with the non-controlling shareholders, the family makes a net gain. This tunnelling behaviour is believed to be widely practised. For example, Enriques and Volpin (2007) believe that 'minor forms of expropriation are systemic in continental Europe' (p. 124). However, because tunnelling is a clandestine activity, evidence on its extent and nature can be hard to come by.

Yang's paper exploits data on land prices in Korea that are reviewed annually by the Korean Ministry of Land, whether or not the land has been traded. He identifies a sample of real estate transactions between a listed firm and the controlling shareholder, and calculates the returns, using the officially assessed prices of the relevant property, over three years before the transaction, and over three years after. He documents that, for sales from shareholder to firm, the average return before the sale exceeds the average return after, while for sales from shareholder to firm, the reverse is the case. The inference is that controlling shareholders are able to obtain a favourable price compared with a fair arm's length price, and/or are consistently able to time the transaction, possibly using private information, so that sales (purchases) are made after large (before) price rises. The loss on average to the firm, estimated from a restricted sample where the transaction price is available, is 26% of the firm's operating profit in the relevant year. The paper provides unusually clear and direct evidence of one type of tunnelling behaviour, and the gains that are made from it.

The four articles included in this special issue will hopefully stimulate further research on corporate governance challenges in emerging economies. They offer new insights and provide promising avenues to advance our wisdom on governance peculiarities in developing countries. These peculiarities may encourage new theoretical lenses and approaches as extant theories developed for established economies may inadequately account for the diversity of various markets (Marquis & Raynard, 2015) and insufficiently fit the governance environments faced by firms in emerging economies (cf. Barkema, Chen, George, Luo & Tsui, 2015). These theories may also benefit from a more comprehensive inclusion of the context and particularly the institutional environment in which firms and their governance are embedded (cf. Filatotchev, Jackson & Nakajima, 2013; George, 2015; Meyer & Peng, 2016).

Conclusion

Political, social, and legal macro-institutions have an impact on governance issues and firm-level governance, which are ingrained in national business systems unique to each country. Governance options and their eligibility may differ significantly across nations, especially between developed and developing economies, depending on these environmental features. Significant corporate governance issues in emerging market nations are covered in this special edition. Further research is still necessary to improve our understanding of corporate governance in developing nations and to educate practitioners and decision-makers about the causes and consequences of different governance arrangements because of the peculiarities of these economies, which differ significantly from the much more extensively studied established economies. In order for some of the research perspectives mentioned in this introduction to soon benefit from fresh and combined insights, we hope that the papers contained in this special issue will encourage and inspire scholars to carry out further study in this area.

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