The Effect of Corporate Governance on Iran Stock Market and Economic Growth

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Abstract. Capital market is one major section in the economy of countries. It is the economic growth that fuels capital market, on the other hand achieving the desired economic growth and development is impossible without efficient financial institutions or sufficient finance sources. The current literature indicates that the development of stock exchange markets depends on good implementation of corporate governance which in turn culminates at increased dynamic economic growth. So in this survey, we investigated the effect of corporate governance on Iran's economic growth during 1994-2010 through using dynamic panel method inspired by General Method of Momentums. The results show that corporate governance is reinforced both directly and indirectly through the positive influence of capital market performance indices on economic growth.

Keywords: Corporate Governance (CG), Economic Growth, Tehran Stock Exchange (TSE), GMM

1. Introduction

Iran's capital market, whose only representative is Tehran Stock Exchange (TSE), is still unable to find its proper place in supplying and equipping financial resources and has been encountered numerous problems. TSE is a governmental organization that follows the decisions of central bank and is independent. The weakness of TSE has caused the accepted companies in this market not to provide, while using various tax exemptions, accurate and timely information for use in capital market, and sometimes to provide individuals with untrue information without being worried about losing their position. Some companies arbitrarily do not distribute dividends, or do not obey other rules and criteria of the exchange. Most of these companies lack an accepted accounting and management system. Hence, financial analysts and brokers achieve the accurate information when it is too late. The basic question is how to recover the lost boom and efficiency of capital market in order to achieve economic growth. The answer to this question lies in the notion of corporate governance. Because according to empirical evidence as Babic[1] corporate governance lead to: (1) creation of Key institutions that direct the success of the economy transformation based on the market; (2) efficient allocation of the capital and the development of the financial market; (3) attraction of foreign investments; and (4) contribution for the process of national development. According to Monforte [2] good corporate governance certainly makes businesses safer and less exposed to external or management risks". Levine and Zervos [3], analyzing 41 stock markets in the period of 1976-1993 in 24 different countries, had found strong correlations between development of the stock market and economic growth. Andrezo and Lima [4], found the positive impacts that a developed financial system provides to the economy, in terms of productivity, capital accumulation, increase of savings and investments and economic growth. Matos [5] finds significant evidences of the bidirectional effect between financial development and economic growth in Brazil. Teixeira [6] strengthens that the economic development is determinant of the development of the Brazilian stock market, and a developed stock market only occurs through the search for a sustainable standard of economic growth. Rogers, Ribeiro, Securato [7], they work had for objective to test the sensitivity of the companies who adopt practices of corporate governance, measured by the Index of Corporate Governance (IGC) of the São Paulo Stock Exchange, in relation to the economic growth, comparatively to the sensitivity of those companies who do not adopt them. In general, the study found evidences on the inter-relationship between economic growth, stock market and corporate governance in Brazil. In the Brazilian stock market, companies who adopt better practices of governance can collect more

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benefit from the economic growth than companies who do not adopt good practices of corporate governance. Tiwari [8] estimated the impact of the performance of corporate governance on economic growth in a cross-country framework in two specifications. The study result shows that performance of corporate governance is significantly negatively related to the economic growth in both specification and in all models and hence it matters not only for the current year but it continues to persistent in future also.

This work has as main objective to investigate the relationship between total corporate governance indicator, Tehran stock exchange efficiency and activity indicators and economic growth over the years of 1994-2010. The main question that will be address in this paper is: whether corporate governance influences on economic growth through the promotion of performance indices in Tehran's stock exchange market. The results of our study indicate that the government size and inflation affects the economic growth adversely, but the effects of 3 other variables (total CG index, compound indexes of total CG index and TSE efficiency and activity index and lag of GDP) are positive. As expected the improvement of corporate governance in capital markets promotes the economic growth. This article is structured in four other sections beyond this introduction. In the next section we consider the position of Iran capital market and corporate governance. Section three contains research methodology. In section four it will be presented the results and the implications of the results.

2. Position of Iran capital market and corporate governance

2.1. The Position of Capital Market in Iran's Economy

Over the past years, state companies and organizations have prevailed in exchange transactions and have caused more instability rather than stability in the market. Moreover, high share of public sector in stock exchange transactions has laid heavy governmental relations on exchange activities. As a result, institutional shareholders have become state or quasi-state which is one of the most important flaws of Iran's capital market. Considering the pillars of TSE such as exchange council, board of securities and etc. suggests that they have a completely state nature. This situation has led to decreasing efficiency and flexibility of it and not using potentials of private sector. One of the important elements in the capital market is information. Existence of asymmetric information in Iran's capital market has led to lack of transparency and consequences such as financial corruptions, informational rent, lack of a concentrated and consistent regulatory system, inexpressiveness of rules, not paying attention to audit report by public assemblies of companies, election of incapable non-expert managers. Also a highly impressionable capital market by non-economic issues has prevented activists from predicting the development trend of the market. This situation has caused economic instability and insecurity and thus has made the capital market and investment activities in Iran face serious threats and obstacles. Hence, despite the high capacities and potentials for growth and development of capital market in Iran, threats and challenges existing in the market have kept it undeveloped and have small effect in financial activities. Therefore, this market does not enjoy the appropriate and desired position in the economy.

2.2. CG in Iran's capital market

CG is a new concept in Iran and TSE. The CG code introduced by TSE authorities at the end of 2007 concentrates on only internal framework like ownership concentration, board and board remuneration while it pays no attention to external framework (such as market control). In addition to listing rules and disclosures, the listed companies must inform the Exchange about dividends, annual general meeting (AGM), capital increases and changes in boards. However, the quality of disclosure in Iran's capital market is lower than developed, emerging and many under-developed countries that leads to reduced desirability of Iranian capital market to attract new capital and foreigner investors. Shareholders' basic rights, especially minority shareholders, are not well protected in Iran. Central Depository Committees do not exist in Iran so the shareholding process of shareholders cannot be recorded. The minority shareholders cannot participate in AGM and do not have a representative among board members as well as a suffrage in AGM for electing board members. Furthermore, their dividends are never paid at the appointed time. TSE annual reports suggest that the only about %30 of companies pay dividends. According to regulations, shareholders can complain to TSE about non-payment of dividends. In other word, such trends effectively reduce shareholders' protection against abuse. Table 1 acknowledges our arguments.

Table1. Implementing the five pillars of CG

	Board structures and responsibilities	Transparency and disclosure	Shareholder rights	Commitment to CG	Ownership and control
Iran listed companies	35%	32%	33%	23%	25%

Source: Authors' calculations

Low indices indicate poor and opaque performance of listed companies on TSE. This leads to reduced investors' trust in the firms' performance and their reported results and causes the utility of this market and participating companies to reduce for investment. The ultimate result for Iran's capital market has been nothing but low market return, firms' bankruptcy and outgoing the market, not to attract foreign investors, and capital market losing its desired position in Iran's economy

3. Research methodology and result analysis

3.1. Data and Descriptive statistics

The data of the present research are drawn from different sources. To do so, 110 TSE listed companies were selected among 10 industries as a TSE proxy for the period 1994 to 20101. Then the data were extracted from companies' published financial reports by TSE and companies' websites. As well the information about GDP, government expenditure and inflation gathered from Iran central bank balance sheet.

3.2. Methodological Framework

In order to construct corporate governance index for the firms listed on TSE, a broad, multifactor corporate governance rating is done which is based on the data obtained from the annual reports of the firms. The index construction is as follows: for every firm, there are 20 governance proxies or indicators are selected, these indicators are categorized into five main themes. The five categories have shown in Table (2). The weighting is in the construction of index is based on subjective judgments. The assigned priorities amongst and within each category is guided by empirical literature and financial experts in this area. The maximum score is 100, then, a score of 100 is assigned if factor is observed, 80 if largely observed, 50 for partially observed and 0 if it is not observed[2]. The average is taken out and we arrive at the rating of one sub-index. By taking the average of five sub indices we obtain CGI for a particular firm. Each sub-index comprises of series of factors leading to measure corporate governance. Board composition index captures board autonomy, structure and effectiveness. The purpose of ownership and control sub-index is to measure the degree to which the board and managers have incentives that align their interest with those of shareholders. The disclosure index attempts to measure the public commitment of the firm to good governance. The purpose of commitment index is to measure degree of firms regard to corporate governance. Table2, indicate corporate governance components.

The hypothesis tested here is as follows: Is there any significant relation between corporate governance and economic growth? Based on this to evaluation relationship between corporate governance, stock market and economic growth we use time series regression as fallow:

$$\Delta(LY_t)=\alpha_0+\alpha_1\Delta(LY_{t-1})+\alpha_3\Delta(LX_t)+\alpha_4\Delta(CGI_t)+\alpha_5\Delta(Lmef_t\times CGI_t\times Lmact_t)+\varepsilon_t \qquad (1)$$

The dependent variable, Y_t, denote logarithm GDP growth, t $\in$ [1,…,T] (T denotes the terminal date of the sample), CGI_t denotes the CGQ index, logarithm X_t denotes all other variables that affect Y_t, that in this study these variables are: government expenditures and inflation, and (lmef*CGI*lmact) indicate relationship between corporate governance and capital market indicators. We use GMM method to estimate

2. This is based on the report of World Bank, Report on the Observance of Standards and Code (ROSC), Corporate Governance country assessment: Pakistan' June 2005.

which improves stability through reducing the sample bias and it is inspired by Time Series Theory as well. The study time period is 16 years.

Table 2. The components of corporate governance

Sub-index 1 :The directing board
1-The board size 2-Separated positions for managing director and board head 3-Board sessions 4-Out-sourced managers 5-Contribution of out-sourced managers in board sessions 6-Do managers represent minority shareholders 7-combination of board
Sub-index 2: Shareholders
1-Dividend Policy 2- External share-holders 3- Black Holder Company (share holders with share ownership of 25% or higher)
Sub-index 3:Transparencies, Disclosure and Auditing
1-Is the fee paid to external auditors for their auditing services are specified? 2-Is the information published by the company is confidential and high-quality 3-Is the disclosed information published timely and promptly? 4-Is the compensation paid to the board members known? 5-Is the implemented corporate governance is completely clear.
Sub-index 4 : Requirements and undertakings
Dose the company guarantee the establishment of a corporate governance committee.
Sub-index 5: Ownership and corporate structure
1-whether companies blockholder are specify? 2-specifying number of boards 3-internal audit 4-Specifying the ownership of blockholders

Source: world Bank

4. Results Analysis

According to the tabulated results in Table (3), estimated coefficients and their signs are consistent with current theories. As the results show, the government size and inflation affects the economic growth adversely and their disproportional hikes impedes economic growth, but the effects of 3 other variables are positive. As expected the improvement of corporate governance in capital markets promotes the economic growth, because referring to the previous sections of this chapter, an improved corporate governance increases both the market value and the efficiency of accepted enterprises in the stock exchange market which both attract local and foreign investors to this market and promotes it which in turn will improve the economic growth. Also corporate governance affects the economic growth through influencing on the capital market performance indices i.e. the market activity index and the market efficiency index. Due to lack of strong legal supervision of enforcement about corporate governance inside the accepted companies in TSE and absence a comprehensive guideline about corporate governance, lack of enough knowledge among Iran's stock exchange market practitioners about the concept, role and positive impact of corporate governance, the dominance of money market over capital market and the governmental nature of this market and as it is a newly introduced concept in Iran , the corporate governance index has very little effect through stock exchange efficiency indices. Due to the conducted study, our hypothesis which postulates a significant relation between corporate governance and economic growth is certified. Also the answers to both aforementioned questions are positive.

Table 3. The relation among corporate governance capital market and economic growth 1994-2010

Explanatory variables	coefficients	probability
D(LY(-1))	0.0343	0.0000
D(LGS))	-0.1924	0.0000
D(LCPI)	-0.791	0.0000
D(CGI)	0.0612	0.0000
D(lmef×cgi×lmact)	0.000257	0.0025
J Statistic= 0.2736	P-Value: 0.8721	Wald Test Statistic: 95757.42

Source: Authors' calculation

5. Conclusion and Discussion

The goal of this article is to study the relations among corporate governance, stock exchange market and economic growth in Iran. The results show that corporate governance either directly or indirectly through influencing on capital market performance indices improve economic growth. So corporate governance promotes economic growth through capital market boom and effectiveness. But a major concern in this scenario is the weak corporate governance of Iran’s capital market, lack of showing attention by accepted companies of this market and lack of a comprehensive guideline. Due to the contribution and effect of corporate governance on economic growth hence, this is a strong recommendation that capital market authorities make any attempt to provide a CG charter suitable for the economy and capital market regarding international CG standards and oblige listed companies to observe it. They also should try to establish a committee titled as "Corporate Governance" for reviewing and ranking companies based on the CG observance and publish their reports annually. It is also recommended to hold several conferences and seminars every year with the attendance of successful countries in this area to use their experiences. Requesting international organizations' assistance with this issue is a benefit.

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