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ECONOMIC**REFORM**
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January 31, 2013

Looking Toward the Future: The Business Case for Corporate Governance

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Article at a glance

- In today's global economy, corporate governance is becoming increasingly recognized as a key factor affecting businesses' success in emerging markets.
- In order to strengthen private sector governance, countries and companies should also focus on broader reforms of the judicial systems, property rights, freedom of information, and other institutions key to market economies and democratic governance.
- An effective corporate governance framework supports a foundation for sustained growth and a stable and vibrant global economy in the future.

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This piece was originally published as a chapter in Essays on Governance: 36 Critical Essays to Drive Shareholder Value and Business Growth*, by Andrew J. Sherman (Advantage, 2012).*

Preface

Historically, in the developed economies, key drivers for the adoption of good corporate governance have been the following: the search for investment capital, the desire to list on major global stock exchanges, the need to gain access to technology, and the desire to build solid supply chains. In today's global economy, corporate governance is becoming increasingly recognized as a key factor affecting businesses' success in emerging markets as well.

Opportunities and competitive threats created by the global economy make instituting good corporate governance practices key to developing a strategy for the company to prosper. Improving corporate governance allows companies to attract greater investment at lower cost, strengthens corporate strategy and its implementation, clarifies accountability, enhances shareholder protection, and helps to attract and retain quality employees.[1] This is true not only for large publicly-listed multinationals but for other types of companies as well. For controlling shareholders, corporate governance clarifies roles and improves accountability, enhances senior executives' professionalization, and increases company value.[2] Crucially, for society as a whole, corporate governance minimizes the occurrence of corruption, reduces the risk of devastating systemic crises, and improves productivity.

Understanding Corporate Governance

Corporate governance is at the core of a modern company's strategy and operations because it addresses issues vital to that company's performance and to its very survival. From board selection and strategic decision-making to day-to-day operations and legal compliance, corporate governance is a way for companies to create a framework for sound business practices, sustained growth, and risk management.

The basic concept of corporate governance is a principal-agent model used to ensure the profitable performance of corporations and the efficient use of resources, and to solve problems related to the separation of ownership and control.[3] The principals are owners of company assets; the agents are managers responsible for company operations. The idea behind corporate governance is to ensure that the agent – the manager – acts in the best interest of the principal. Therefore, at its core corporate governance entails an internal control system for transparent decision-making to which company executives should be held accountable.

In this basic model, directors represent the shareholders; vote on key matters and appoint and monitor the management, while the management carries out core company functions and reports to the board of directors. Many people think of corporate governance as limited to this internal company dynamic between the shareholders, board of directors, and management. The revised Principles of Corporate Governance published by the Organisation for Economic Co-operation and Development (OECD) in 2004 capture the essence of that dynamic:

> "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined."

However, the OECD Principles also make it clear that corporate governance involves more than just internal company structures and requires external supporting institutions that promote transparent and efficient markets.[4]

Many people also think of corporate governance as something applicable only to large corporations in developed economies with little relevance to the broader private sector or to issues affecting the development of countries around the world. In the global economy, however, it has become increasingly obvious that the external factors that guide the behavior of companies, such as regulatory frameworks and market institutions, are equally important to making the system of corporate governance work. Moreover, in many countries publicly listed corporations are not the most important economic actors in terms of employment and growth. Instead, other types of business – from family-owned companies to small enterprises – play a dominant role in the economy. Those companies also need good corporate governance for better sustainability and in order to become integrated into the global supply chains.

As a result, the understanding and application of corporate governance has evolved in the last few decades, as people recognize that corporate governance does not exist in a vacuum. Its successful implementation depends on a country's overall institutional environment, not just on a company's internal practices. Therefore, to strengthen private sector governance, countries and companies alike should also focus on broader reforms of the judicial systems, property rights, freedom of information, and other institutions key to market economies and democratic governance.[5] These institutional dimensions of corporate governance must be understood in order to appreciate corporate governance's importance for business growth, especially in emerging markets.

Institutional Dimensions of Corporate Governance

The external factors that affect corporate behavior include various stakeholders who need to be considered in decision-making, such as employees, customers, suppliers, lenders, and communities in which the company operates. Reputational agents, such as accountants and independent auditors, lawyers, credit rating agencies, investment bankers and advisors, financial media, and corporate governance analysts, are also crucial in shaping company decisions. So are shareholder rights organizations, corporate governance institutes, and directors' associations, given their role in corporate governance-related advocacy, professional standards, and self-regulation.

> The successful implementation of corporate governance programs depends on a country's overall institutional environment, not just on a company's internal practices.

Another key external factor is the regulatory environment. It involves various standards (accounting and auditing, for instance); laws and regulations applied to companies; stock exchange and securities market regulations; debt and equity requirements of the financial sector; rules governing market competition; investment; and corporate control.

The growing recognition that corporate governance requires the functioning of both internal controls and external supporting institutions is illustrated by the evolution of the OECD Principles of Corporate Governance. The OECD Principles were created in 1999 and initially focused on five core areas of corporate governance: the rights of shareholders and key ownership structures; equitable treatment of shareholders; the role of stakeholders; disclosure and transparency; and the responsibilities of the board. However, it soon became apparent that this scope did not sufficiently reflect the external, institutional factors that drive corporate governance.

When the authors drafted the original Principles, they primarily looked at the OECD countries with developed capital markets and well-established corporate structures. The Principles assumed that all the other institutions of a market economy were in place. Furthermore, they did not touch upon forms of business common in many countries such family firms or state-owned enterprises (SOEs), nor did they address the differences between dispersed and concentrated ownership structures. Those shortcomings highlighted a discrepancy between the traditional definition of corporate governance and its actual practice.

That is why, in 2004, a revision of the OECD Principles added another key tenet to the existing five: ensuring the basis for an effective corporate governance framework. It states that "the corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities." This principle now makes it explicit that the existence of good public governance and market institutions cannot be assumed and should be enhanced through reforms where needed.

The revision process, in which the Center for International Private Enterprise (CIPE) and its partners from around the world participated, also captured the fact that the value of corporate governance goes beyond the performance of individual companies. The private sector, as a whole, plays a vital role in market economies and development prospects of countries. Therefore, institutions of good corporate governance – in order to operate effectively – must exist in the context of broader institutions that guarantee transparent governance and competitive markets.

Business Case for Corporate Governance

Given that corporate governance is relevant to individual companies and countries alike, building a business case for implementing good corporate governance practices has two equally crucial aspects: it needs to demonstrate benefits both at a company level and at a systemic country level.[6]

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Business Case for Companies

As mentioned earlier, corporate governance traditionally has been associated with large companies in developed markets for which the key benefit of good governance is being listed on a stock exchange and able to raise outside capital. However, corporate governance can deliver benefits to other types of companies because it provides a framework for efficient, transparent, and accountable decision-making. That framework is needed in every enterprise regardless of the size or form of ownership. All companies must have a way of reconciling divergent interests, planning for strategy and succession, accessing capital, cultivating company image in the community, and ensuring legal compliance. Corporate governance is a key tool for achieving those business goals.

Family firms are one such example. Given that their owners and managers are the same, the conventional model of corporate governance has generally not been deemed applicable to them. Yet, those firms – prevalent in many developing countries – face serious governance challenges that require clear rules and decision-making frameworks. Common problems in family-owned firms include nepotism, personal conflicts between different family members, lack of clear separation of interests and assets between the company and family, and succession issues that threaten the company's survival beyond the founder.

In those companies, good corporate governance can, among other qualities, help ensure sustainability in the second and third generations, improve professionalism of management, enhance access to capital, and increase the price and volume of traded shares. Better corporate governance practices also help family firms achieve clearer distinction between representatives of the ownership (directors) and of management (CEO and other executives) and improve the quality of decision-making by recruiting independent board members. Those findings have been borne out by a study of corporate governance practices of 15 largest family-owned companies in Brazil.[7]

Improving corporate governance in the state-owned enterprise (SOE) sector is another example of benefits at a company level. By adopting good corporate governance rules, SOEs can make the state an effective and more responsible owner, improve board quality, tie management incentives to company performance, and establish clear lines of accountability that ultimately go back to the taxpayers.[8]

Small and medium-sized enterprises (SMEs), although not associated with the classic corporate governance model, can also greatly benefit from improved internal governance. Most leaders of SMEs cite access to credit as one of the biggest challenges they face, especially in economies where capital markets are underdeveloped and small companies primarily rely on banks for financing. Without proper accounting procedures and disclosure of financial information, bank loans are not forthcoming.

Many SME leaders are recognizing the need to improve their companies' accounting procedures and internal control systems to enhance their credit worthiness. They also see the economic value of crafting internal codes of corporate governance for greater sustainability and competitiveness. By adopting such codes, SME leaders can improve the decision-making process between partners or shareholders, the transparency and accuracy of financial information, the role of executive staff, and the relationships with stakeholders.[9]

By requiring better financial information from companies to which they lend, banks can encourage the adoption of improved accounting systems and regular reporting in various types of companies. In doing so, the banking sector can promote good governance in countries where most companies rely on banks rather than stock exchanges to meet their capital needs. To do it effectively, however, leaders of banks themselves must appreciate the benefits of good corporate governance practices.

Financial crises plaguing countries around the world have frequently been linked to insider lending or improper risk management in financial institutions. Those risks are particularly compounded in state-owned banks in which, without proper safeguards, political considerations often trump sound economic decision-making and risk assessment in lending. That is where corporate governance – through more transparency and accountability in the boardroom and through better disclosure – can make a big difference, not just for responsible bank lending but also for macroeconomic stability.

In fact, systemic failure of risk management tied to poor corporate governance practices has been at the core of the recent global financial crisis. As the OECD report on the causes of the crisis observed, "In many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy. (…) Most important of all, boards were in a number of cases ignorant of the risk facing the company."[10] The lesson is that risk management was typically not covered, or insufficiently covered, by corporate governance practices. Many companies, including banks, have since improved board performance in this regard by developing policies for identification of the best skill composition of the board or establishing remuneration committees to better monitor the relation between executive compensation and company performance and anticipate potential conflicts of interest.

Business Case for Economies

The institutional underpinnings of corporate governance, especially the private sector institutions and regulatory framework that shape business behavior, make it an essential component of public governance and economic development of countries. Many efforts toward strengthening corporate governance in emerging markets have been focused on improving internal company practices. However, improving the broader institutional environment in which those practices are implemented is of equal importance because of the intertwined nature of the internal and external factors that influence business conduct.

Addressing institutional deficiencies that hamper effective corporate governance is one of the core benefits of corporate governance reforms, particularly for developing economies. At the most basic level, a sound corporate governance system helps to ensure that companies operate on a level playing field and that the rights of shareholders and stakeholders are well defined and protected. More broadly, corporate governance requires institutions, such as healthy justice system, to enforce the rules and vibrant civil society and independent media to monitor company conduct and expose abuses. Building these supporting institutions of corporate governance facilitates the creation of value systems based on transparency, accountability, responsibility, and fairness. Those values are not only important for ethical and sustainable business growth but are also indispensable for democratic governance.

One key area in which countries can greatly benefit from improved corporate governance is in privatization of state-owned enterprises. Introducing good corporate governance in companies scheduled to undergo privatization is particularly crucial in transition economies, in which privatizing state assets is a key part of building a market economy and in which governments depend on income from privatization to deliver services to the public.

The legacy of flawed privatization after the fall of communism in Eastern Europe shows how the lack of proper internal controls, reporting mechanisms, and shareholder protections in privatized firms led to corruption and abuse detrimental not just to those enterprises but to the entire transition process.

The lack of such controls prior to privatization has also contributed to other severe economic crises, such as that of Chile in the 1970s, in which family owned banks unsustainably invested in privatized companies, or the 1994 "tequila crisis" in Mexico, in which government-owned commercial banks were improperly privatized.

Sound corporate governance is also important in state-owned firms with no immediate plans for privatization. In many countries, SOEs account for a large share of employment but are notorious for asset wasting, mismanagement, and entering into political entanglements. Establishing internal controls and clear governance rules can greatly improve the efficiency of their operations and effective use of public resources.

Corporate governance is also crucial for transforming the relationship between businesses and the state away from cronyism and preferential treatment toward transparency and accountability. As financial crises in Asia and Russia in the late 1990s demonstrated, non-transparent relationships between government officials and companies can lead to economic collapse, not just individual company failures.

More recently, the aftermath of the global financial crisis shows the high cost of poor corporate governance for societies that is still felt around the world. All these examples illustrate that weak corporate governance at a company level has crucial macroeconomic implications and can lead to the inability of countries to attract investment, to public asset stripping, to state capture, and, in extreme cases, to financial disaster.

Corporate governance can also be a key anti-corruption tool with many economic benefits.

Certainly, legal reforms, such as better procurement codes or simplification of tax codes, are needed to create stronger anti-corruption environments in countries but robust corporate governance at a company level can greatly supplement such reform efforts. Internal controls limit opportunities for corruption by making bribery harder to conceal, integrating the values of transparency and accountability into a company's operations, and implementing strict policies of zero tolerance for corruption among employees and directors.

In sum, corporate governance clearly delivers palpable economic benefits to countries that put in place better internal and external drivers of company conduct. Studies show that those benefits include higher investment levels, lower costs of capital, and lower costs of doing business, all of which lead to stronger economic growth and more employment opportunities.[11] Improved company performance, through better management and allocation of resources, helps to create wealth and better relationships with stakeholders help improve social and labor relations. Finally, at the systemic level, better corporate governance can help reduce the risk of devastating financial crises.

Drivers of Better Corporate Governance: In Search of Benefits

Corporate governance reforms can be driven by two distinct factors: crises or searches for benefits. Responses to crises are often rushed, tend to focus on new regulation and stricter penalties, and do not take many issues affecting corporate behavior into the account. A better approach to corporate governance reforms is the one driven by a search for benefits: for example, the business case for companies and economies to embrace better corporate governance and be proactive about it, rather than simply react to crises. That, in turn, makes them better prepared to deal with a crisis when it does occur.

When considering the significance of corporate governance for business growth, it is therefore important to recognize that drivers of corporate

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governance are not limited to the rules and competitive pressures that discipline companies into compliance. There are also many positive drivers that incentivize companies to implement good corporate governance in search of benefits, such as attracting investment and lower cost of capital.

A well-governed company, even in a poor investment environment, can do better than its competitors, and that is the premium an investor will pay for. According to the Global Investor Opinion Survey conducted by McKinsey and the Global Corporate Governance Forum, (the survey canvassed more than 200 professional investors in 31 countries in Asia, Europe, Latin America, Middle East, Africa, and North America), a significant majority of investors say they are willing to pay a premium for a well-governed company.[12] Corporate governance also helps strengthen competitiveness. Studies show a link between stronger shareholder protection and larger stock markets,[13] stronger corporate governance and lower cost of capital,[14] and greater equity rates equal higher returns on investment relative to the cost of capital.[15]

That said, there is no silver bullet or a single model of good corporate governance that would automatically translate into business growth. Corporate governance systems and their effectiveness in different countries vary depending on the following: if ownership and control of firms is dispersed (as in the United States and United Kingdom) or concentrated (as in continental Europe, Japan, many of the emerging markets); what legal and regulatory frameworks as well as historical and cultural legacies are in place; and which industry sectors are considered.[16] Various models used by companies have their own strengths and weaknesses and the search for best practices and benefits should be considered in that context.

Universally, though, the key benefit that corporate governance can deliver to companies around the world comes down to building a board that performs, since it is the board members who ultimately contribute to generating sustainable business growth. Implementing good corporate governance is, therefore, not a matter of simply ticking a box; rather, it is a process where the core values of transparency, fairness, accountability, and responsibility are integrated both into a company's strategic direction and its day-to-day operations.

Those values can become institutionalized only if a company adopts a robust code of corporate governance, and the board members fulfill their fundamental duties of care and loyalty to place the company's interest always above board members' personal interests. As demonstrated by the failures of corporate governance that contributed to the recent global financial crisis, it is also crucial for the board members to properly understand the business judgment rule and make informed decisions that responsibly take into account the level of associated risk. Good corporate governance is, therefore, a key tool for ensuring ethical business conduct and managing risks.

Skeptics may say that if a company follows good corporate governance and ethics principles it may, in the short run, lose a business deal to a company that is less scrupulous. In an interconnected modern market economy, however, that works only once. Well-run companies that are consistently profitable have to be able to do business repeatedly with the same customers. Thus, ethical business practices translate into the ability to retain existing customers and gain new ones. They also have a positive impact on attracting and retaining top talent, and improve relationships between employees and management. Finally, ethical business practices matter for a company's reputation and long-term prospects. Managing today's global supply chains and serving increasingly value-conscious consumers requires being able to demonstrate proper and fair conduct all the way down that supply chain, including to sub-contractors and vendors.

People should also keep in mind that business ethics comprise a set of evolving guidelines – and the standards in most societies keep going up. Conduct that was acceptable 50 or even 20 years ago in the area of equal employment opportunities or environmental protection, for instance, is no longer acceptable today. Similarly, the current standards keep evolving, especially through the rising pressure on board members to become more sophisticated in risk management, in light of the global financial meltdown. As standards change, companies need to revisit their corporate governance guidelines and ethics codes to update and refresh them as needed.

Conclusion

The essence of inclusive market economies is the institutional framework where private entrepreneurs have the opportunities to create and build wealth, to maximize their value to society, and to grow the economy of their countries. Corporate governance is a key element of that framework because it helps create a fair level playing field among companies. Corporate governance can also become a focal point for reform of broader institutions needed for a well-functioning market economy: property rights, judicial system and enforcement mechanisms, securities markets, free press, rating agencies, and other checks and balances.

The importance of corporate governance in today's global economy is magnified by the fact that the principles of good corporate governance are applicable to a wide variety of firms, not just large companies listed on major stock exchanges. From SOEs to family-owned firms and SMEs, corporate governance offers a valuable toolkit for introducing transparency, accountability, responsibility, and fairness into the decision-making, helping to ensure greater competitiveness and sustainability.

By improving company procedures and by building responsible boards, corporate governance contributes to business growth. Yet, its significance goes beyond improving company performance and maximizing shareholder value. The external drivers of corporate behavior, from the regulatory framework to independent media, are equally important as internal controls, and reforming them helps to transform the institutional framework in which companies operate. That transformation is of great significance for businesses conducting business in emerging markets and for the overall development prospects of those countries.

Efforts to reform corporate governance around the world must therefore focus on both the internal and external factors that drive corporate behavior. Attempting to transfer international best practices in corporate governance into a country where market and public governance institutions are weak will not succeed unless people pay attention to reforming those broader institutions too. Moreover, reformers should seek to integrate the local business community in the process of developing corporate governance codes in their countries in order to create a sense of ownership and opportunities for feedback.

The ultimate goal of corporate governance reforms is to create value systems that guide ethical company behavior and strengthen the institutions and rights that allow businesses to compete fairly and generate economic growth. There are two paths toward improving corporate governance in companies and countries. One is reactive, associated with failures and collapses; the other is proactive and has to do with the search for benefits. Both have been responsible for bringing attention to corporate governance issues in recent years. Yet, it is the latter that shows the business case for corporate governance and provides positive incentives. By helping companies and countries attract investment, reduce corruption, and facilitate institutional reform, an effective corporate governance framework supports a foundation for sustained growth and a stable and vibrant global economy in the future.

Endnotes

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