Journal of
Law and Governance

Vol 10, No 2 (2015)
ISSN: 2206-088X
http://jbsge.vu.edu.au

Journal of
Law and Governance

Vol 10, No 2 (2015)

Professor Anona Armstrong AM
Editor

Published by

College of Law & Justice
Victoria University

Vol 10, No 2 (2015)
ISSN 2206-088X

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Victoria University
PO Box 14428
MELBOURNE VIC 8001
AUSTRALIA

Victoria University's College of Law & Justice, which has sponsored the Journal for the past five years, has completed a memorandum of agreement with the Chinese Northwest University of Law and Political Science. The Law Schools of both Universities will jointly host the Journal under its new name of *Journal of Law and Governance*. The Journal will continue to be listed with EBSCO.

I wish to thank the founding Editors, Professor Ronald Francis, Associate Professor Arthur Tatnall and Dr Kumi Heenetigala and all the Members of the Review Board and those experts in their field who contributed so much to the Journal during its first ten years.

With the change in name, it is timely to refresh the Board. The Journal is seeking a new Editor and inviting new and old Members to join a new Editorial Board. People who are interested in applying for these positions are invited to send an application with a CV to the Editor: Professor Anona Armstrong (anona.armstrong@vu.edu.au) College of Law and Justice, Victoria University.

All articles published in this journal are subject to a process of blind review by at least two reviewers before selection for publication by the Editorial board.

Submissions are welcome for research articles of between about 5,000 and 10,000 words in any area relevant to the journal's wide coverage. Potential articles should, in the first instance, be sent to: Kumi Heenetigala, Victoria University: kumi.heenetigala@vu.edu.au

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Editorial

The Law and Governance in SMEs

This issue of the Journal presents a second eclectic mix of papers from the Governance and Law Conference ranging from a paper concerning the legal issues of piercing the corporate veil, to three papers studies of small business finance, to strategic decisions about the factors affecting investment. It concludes with a paper which addresses the governance issues in the not-for profit sector through the governance of superannuation funds.

The corporations law describes the legal identity of a company as being a ”separate” entity, or having a separate personality from its owners or managers. In an historical development of the legal form of companies David Parker's describes three theories which assist in understanding the role of companies in society, and how and why piercing of the veil has developed. The author argues that contemporary law lacks an adequate definition of a company and the doctrine of piercing is becoming increasingly irrelevant. In this context he proposes a new definition of a company appropriate for today's society.

Geoff Fader, Chair of the Tasmanian Small Business Council and COSBOA board member has been a great supporter of the Small Business studies by the Governance Research Program in the College of Law & Justice. At the conference Geoff introduced the Small Business Section with an address that raised the issue of financial arrangements when the time came to sell or dispose of a small business. This fitted well with introduction of the following three papers on SME finance.

The extent of and continuing growth of government regulation has emerged as a major issue for government. The main problem appears to be compliance and reporting costs. Small business is believed to be the major casualty of this problem. Lewis, Richardson and Corliss's paper describes the results of a study of 391 small businesses NSW and Victoria. It includes estimates of compliance costs for ten types of regulation, their effect on different sized organisations and how the businesses seek assistance from government, industry lawyers and accountants to resolve the difficulties.

The second paper into small business complements the first paper. Li integrated the supply and demand sides of SME finance in a model that analysed access to finance and the different modes of financing available to SMEs. The review found that Australia lagged far behind efforts to promote SME finance in other OECD countries.

Family business is a major contributor to the economy especially in developing countries. Ediriweera et al's paper confirmed that this was the case in Sri Lanka. In a review of the governance of these types of businesses there is a complex interaction between a family and its business raises issues of ownership, control, succession, performance and governance. In particular, these types of business have a distinct governance structure in many cases unique to a specific family business, and involving both unstructured and structured components. A conclusion was that converting a company to a listed entity is dependent on the needs of the business and not essential for growth.

The issues addressed in this issue, from the corporations law to SME governance illustrate that the regulation of law and the principles of governance play complementary roles in all types and sizes of companies.

Professor Anona Armstrong AM
Victoria University

Editor

The Company in the 21st Century: Piercing the Veil: Reconceptualising the Company under Law

David Parker
Victoria University, Australia

Abstract

The corporations law describes the legal identity of a company as being a "separate" entity, or having a separate personality from its owners or managers. Piercing the veil of a corporation occurs when a court disregards this distinction to hold people to account. The paper reviews the historical development of the legal form of companies, three theories which assist in understanding the role of companies in society, and how and why piercing of the veil has developed. The author argues that contemporary law lacks an adequate definition of a company and the doctrine of piercing is becoming increasingly irrelevant. In this context he proposes a new definition of a company appropriate for today's society.

Introduction

'Piercing the veil of incorporation' is a statement which uses the metaphor of the company entity as a 'veil', whereby under some circumstances the courts will not recognise the separate entity of a corporation from its controllers – but will hold those controllers personally liable. The concept of 'veiling' presumes a legal entity exists, and that the entity is separate from its owners and operators; but what this entity actually represents is rather unsettled, both in legislation and in jurisprudence. The modern company is a concept that has evolved from the artificial entities of ancient times, basically as a result of sheer convenience and practicality. The boundaries of that entity have been subject to much criticism and perhaps mysticism as the courts have invented mythology to both create the entity, explain it, but to also constrain it by refusing its separate existence from its members should that mythology be misused.

I propose that the concept of piercing the veil, and in fact the incorporation of a company as a separate legal entity, which is then equated to that of a body with a personality, is not an appropriate analogy. I propose that the analogy of a body, the mythology that views a company as a human like 'organic being' obfuscates the true nature of the company, or at least a perception of what it should be. Similarly, the idea of piercing the veil is inappropriate and has been surpassed by a new reality of the company entity, or at least it should. The legal perception of a company under law has significant implications in whether a company as a humanized form must therefore display the same duties, ethics and social responsibility expected of a human citizen.

Creation of companies

The corporate, limited liability entity is a great invention. One writer described it as equivalent to the invention of electricity! Take the statement of President Nicholas Murray of Columbia University in 1911. I weigh my words when I say that in my judgment the limited liability corporation is the greatest single discovery of modern times … Even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative

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impotence without it.[1] Company law, as it relates to the creation of a company and its regulation has occurred haphazardly and incrementally in order to service each economy in which it sits, e.g. whether that be the growth of railways in the United States, or the facilitation of mining ventures in Victoria,[2] or the encouragement of micro business in Australia in the last 10 years.[3] In the last 140 years since the creation of companies (if we use the English legislation as a benchmark) there has been a massive creation of regulation, particularly in relation to directors and officer's duties in the way the company must operate in keeping records, procedures etc. However, there is little in company legislation that states what essentially a company is designed to do, nor its responsibility to the community – at least in the process of its creation.

Company legislation in Australia does not define the role of company in our society

Under Australian legislation there is no statement as to what the company actually is but a rather vague reference that it is a separate entity according to law, with no further explanation of what that means, something which is then left to the courts to determine. The lack of any direction by statute means that it is difficult to determine whether the company is a human like body, or not, and in turn whether there can be a claim to citizen's rights, and further whether such 'privileges' accordingly require human like ethics and responsibilities.

The corporate entity is defined in s 9 of the *Corporations Act 2001* (Cth) but silent on the notion of the personality of a company, with simplistic statements that a certificate of registration is conclusive of registration.[4] The company comes into existence at the beginning of the day it is registered: s 124 then states that a company has the legal capacity of an individual, as a legal person without explaining what that 'person' actually is. The *Acts Interpretation Act 1901* (Cth) similarly gives little explanation of the term 'person', in s 2C the term 'person' includes a reference to companies, corporations or bodies corporate, thereby leaving to other sources of law to explain a company. A survey of the legislation from other common law countries demonstrates similar bland statements as to the meaning of registration, e.g. the *Companies Act 1989* (UK) gives no guidance as to the separation principle with very open statements as to the essence of a company, for instance: 's 1(1) Any two or more persons associated for a lawful purpose may, by subscribing their names to a memorandum of association and otherwise complying with the requirements of this Act'. It is the symbology of the common law which has equated the legislated entity to that of natural person with comparisons to bodies, arms, organs and brains.

The response of the courts has been to equate the company with that of a natural person in order to give themselves extensive powers in determining the distinction between a company and its members. The courts have been forced to interpret the Corporations Act in such a way because of its complexity and gaps of the Act, particularly in relation to a lack of any stated policy within the Act.[5] The Corporations Act is more of a regulatory document, remaining silent on policy issues, unlike for instance the Income Tax Assessment Act (Cth) 1997 which very clearly states policy and intention as a preamble to each chapter of the Act.

In the absence of legislative guidance it is the common law which provides the principle that companies are separate from their owners and controllers, basically starting with the celebrated Salomon case, which without stating anything in particular about corporate entities, firmly established

[1] Quoted in William Hackney & Tracey Benson, 'Shareholder Liability for Inadequate Capital' (1982) 43 *University of Pittsburgh Law Review* 837, 841.
[2] E.g., the creation of a non-liability company in Victoria to facilitate risky ventures during the gold rush in the 1800s.
[3] E.g., the creation of one person companies.
[4] Issued by the ASIC after specific formalities have been fulfilled: ss 118 & 119 *Corporations Act 2001* (Cth).
[5] Dimity Kingsford Smith, 'Interpreting the Corporations law – Purpose, Practical Reasoning and the Public Interest' (1999) 21 *Sydney Law Review* 161. Dimity Smith refers to a type of stratification of law whereby statutes are regulatory and deliberate acts of transformative social policy whereas equity and contract are for private interests.

the separateness of the corporate entity from its promoters and operators.[6] An apt comment in a case note, attributed to Sir Frederick Pollock,[7] sums up the problem: 'Our Legislature…delivered itself on the Companies Act in its usual oracular style, leaving to the Courts the interpretation of its mystical utterances'. In a further comment, the same writer states: 'The House of Lords has said … that the one trader and the six dummies will do, treating the statutory conditions as mere machinery'.[8]

Equating a company with a human person, the use of metaphors

Humans have always used allegory to explain their relationships, their obligations and their consequent liabilities; the law contains many examples of such 'inventions' in order to facilitate property holding, legal action or contractual agreements. There are two aspects to the use of the metaphors in relation to companies, the first is that the metaphor can take over and become the law itself, and secondly the use of metaphors may substitute for a real analysis of what the personhood of the company actually is.

Probably the essence of the first 'modern' companies (if we focus on British companies), is that the essence of incorporation was to recognize legally a company of persons, with common interests, knowledge and cooperation with each other, rather than the large corporate bodies now existing, with little interaction of its company members,[9] particularly pronounced by the separation of ownership and control in a large modern company.

The idea of a legal personality is one such creation of the legal system, which begins with a recognition of humans as having a recognised legal entity, at least in modern times, [10] while restricting the legal 'abilities' of some categories of humans e.g., children and the mentally impaired. The extension therefore of a legal personality to other artificial entities has developed out of sheer convenience in order that the entity can carry out everyday functions of holding monies, entering into contracts and appearing in court,[11] albeit through human agents.

Entities similarly have certain abilities within the law, while being denied other rights which may be available to a natural (human) entity.[12] Governments, corporations and even an idol[13] may be deemed to have a legal personality for the purposes of law. The legal persona then operates through its agents, and in order to do this the law has therefore created a collective known as a body corporate, a created entity to which it ascribes certain legal characteristics. This body then has the right to enter into relationships that give rights to that body, while at the same time imposing liabilities and responsibilities on the creation designating that body as a legal person. To explain that body there is an expansive use of metaphor and equation of human rights (and liabilities) to entities such as

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[6] *Salomon v Salomon* [1897] AC 22.

[7] (1897) 13 *Law Quarterly Review* 6, the case note was anonymous but Sir Frederick Pollock was the editor and is assumed to be the author.

[8] Ibid Pollock.

[9] The word 'company' has been suggested as one of 'breaking bread together', pane referring to bread. Compagnia, a form of partnership firms that dominated medieval Italian cities from the thirteenth to the sixteenth century, literally meant sharing bread (L. panis) together (L. com), the partners are sharing everything together: Collins Concise English Dictionary (Australian 1991). Paul Redmond refers to word company as possibly 'cum pane' literally 'with bread', your companion being the one with whom you break bread: Companies and Securities Law, 2000 LBC.

[10] Historically slaves, monks, unborn children and prisoners were deemed in different societies, at different times, to lack any civil entity or personality and hence rights.

[11] *Molnar Engineering Pty Ltd v The Herald and Weekly Times Ltd* (1984) 1 FCR 455. A company cannot appear in court without a representative.

[12] Noting that companies may have individual rights not available to humans eg, the right to issue shares: s 124 *Corporations Act 2001* (Cth). Interestingly in the city of Melbourne, Australia, companies have the right to vote in local council elections if they pay rates, admittedly through the person of a director or company secretary. See Victorian Electoral Commission at http://www.vec.gov.vic

[13] *Pramatha Nath Mullick v Pradyumna Kumar Mullick* [1925] L R 52 Ind App 245: this was an Indian case which was decided in England on appeal. See also Patrick Duff, 'The Personality of an Idol' (1927) 3 *Cambridge Law Journal* 42.

companies.[14] Those metaphors both create a human like persona for companies, but are also used to undo that persona, to discard the separate legal entity so presumed, in order to hold the humans behind the entity personally liable by undoing their protection in the event that they misuse the corporate form. George Paton[15] makes the observation that Greek philosophy imputed the persona as being more about the individuality of a human, 'the rational substratum of a human being', whereas it has been interpreted to designate a human as a 'right and duty bearing unit',[16] a different concept altogether. Interestingly the term 'personality' purportedly derives from the Greek word *per-sonare* and *persona*, being an actor's mask behind which stood the anonymous speaker.[17]

The Romans adopted the ideas of the Greeks and developed further the notions of corporate entities with a legal persona, whereby some bodies were recognised in law as capable of having legal rights, but also bound by certain legal duties – though not necessarily in the same strict sense as today.[18] Patrick Duff's study of Roman law demonstrates the Romans had a very unsophisticated idea of legal personality, he refers to writings with 'hundreds of passages where *homo* could be substituted for *persona* without any apparent change in the sense'. Roman law had no particular advanced theory on artificial entities, but the barest principles were adequate enough to cope with the activities of collegia, societates publicanorum, hereditas iacens, municipalities and charities.[19] The use of the corporate personality to facilitate the holding of property by these ancient peoples is interesting in that they developed the notion of a separate entity, but did not equate this with a human in terms of its rights and civil liberties.

Note that the idea of the mask has also been used in Australia, for instance Windeyer J thought that a company personifies:

> [A] new legal entity, a person in the eye of the law. Perhaps it were better in some cases to say a legal persona, for the Latin work in one of its sense means a mask; Eriptur persona, manet res'.[20]

The metaphors range from the organic method, the idea of the company as a body with a 'brain' and organs that carry out the functions of the company. The metaphors, in the absence of any positive statement by the written law, have become law in itself.

Such metaphors abound in case law. One author[21] identifies 25 different metaphors to describe the use and misuse of a corporate entity as amongst others as a

> …mere adjunct, agent, alter ego, alter identity, arm, blind, branch, buffer, cloak, coat, corporate double, instrumentality, mouthpiece, name, nominal identity, phrase, puppet, screen, sham, simulacrum, snare, stooge, subterfuge, or tool.

In Australia and the United Kingdom, the most popular expression seems to be the use of the metaphor of the veil of incorporation. The expression of a 'veil' is in a sense a judgmental term and one dictionary term has it as 'to conceal (some immaterial thing, condition, quality, etc.) from

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[14] For example the ability of a company to sue for defamation. *McDonalds Corporation v Helen Steel, David Morris* [1993] EWHC QB 366 19th June.

[15] G W Paton, *A Textbook of Jurisprudence*, (ed G W Paton and D P Derham), (4th ed 1972), pp 57–9, 130, 483.

[16] John Dewey, 'The Historic Background of Corporate Legal Personality' (1926) 35 *Yale Law Journal*. 655.

[17] Clement Webb, *God and Personality* (1971), Frederick Hallis, *Corporate Personality: a study in jurisprudence* (1930). See also Max Radin, *The Legislation of the Greeks and Romans on Corporations* (1910).

[18] Patrick Duff, P*ersonality in Roman Private Law* (1938) 19. See his note that persona in Roman law referred to a human rather than a 'juristic entity', see also William Buckland, 'Roman Law of Slavery' (1908) 17 *Law Quarterly Review* 180.

[19] …*hereditas iacens* represented the person of the deceased.

[20] *Peate v Federal Commissioner of Taxation* (1964) 111 CLR 443. However, in a later case: *Gorton v FCT* (1965) 113 CLR 604 at 627. Windeyer J said in an income tax case that he detected '…an increasing tendency of courts in England and perhaps more markedly in the United States, to retreat from the position where they must refuse to look behind the legal personality which the law has given to a private corporation, and to examine the purpose of its creation and the manner of its control'.

[21] R.W. Hamilton, *Corporations including Partnerships and Limited Partnerships* (4th ed 1990) 261.

apprehension, knowledge, or perception: to hide the real nature or meaning of (something)'.[22] Another term often used is that of the 'mask' of incorporation, which again is the use of a 'covering' word and particularly pertinent given that the term persona is derived from Greek theatre, whereby a mask designated a certain character to the world, while the 'actors' remained anonymous.[23] As Paul Redmond states '….corporate personality is a human construct, created to solve human problems…',[24] and similarly Samuel Stoljar states that: 'Although separate legal personality is referred to in absolute terms, it is a relative notion referring to a subject's ensemble of legal rights'.[25] Professor Elvin Latty, an earlier but often quoted writer in this area,[26] offers an interesting statement on the fiction of a company:

> [W]e are . . . told that the corporation admits of a real personality or at least of something so like personality that we may call it by that name; that it is a real person with a body, members and will of its own; that it is an artificial person; that it is a real person because what is artificial is real; that even an individual is after all but an artificial legal person, a subject of rights and duties; that a corporation is not a thing, it is a method; that the entity is a fiction but a rational fiction, not an arbitrary or artificial fiction; that the 'person' is a fiction but the entity or 'thing' is real.[27]

The use of metaphors to explain the idea of corporate personality has itself been criticized, for instance Justice Cardozo in *Berkey v Third Ave Ry Co*[28] said that: 'Metaphors in the law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it'. In the same passage he described veil-piercing as an area of law which is shrouded 'in mists of metaphor'.

Samuel Stoljar provides an Australian contribution and comments that the concept of separate legal personality is a perception that 'responds to our anthropomorphic instincts and runs the risk of retaining, even if regarded as only a fiction, a sort of residual strength'.[29] The separateness of the company detaches its members from personal liability by viewing the company as a metaphorical 'separate personality', 'body' or 'legal person'.[30] The company entity has taken on a life of its own as if the members are passive investors and the controllers work for a personified entity known as the company. Peta Spender takes up the comment by Stoljar pointing out that the concept of separate legal personality exists as both a powerful metaphor and a judicial reality',[31] and later says: 'Unfortunately anthropomorphism has caused the separate legal personality of the family company to assume a life of its own as a persuasive metaphor. As a consequence, the law has focused upon fulfillment of the metaphor rather than the specific regulatory aims of the law in particular areas'.[32] Such observations are not new; Bryant Smith[33] reached a similar conclusion over 70 years ago:

[22] The Macquarie English Dictionary (3rd ed 1998). Interestingly the dictionary defines 'fiction' as a 'something invented or imagined…'

[23] Clement Webb, *God and Personality* (1971).

[24] Paul Redmond, *Companies and Securities Law: Commentary and Materials* (1992) 141.

[25]Samuel J Stoljar, *Groups and Entities: An Inquiry into Corporate Theory* (1972) 4.

[26] Michael J, Gaertner, 'Reverse piercing the corporate veil: Should corporation owners have it both ways?' (1989) *William & Mary Law Review* 667. Carsten Alting, 'Piercing the Corporate Veil in American and German Law - Liability of Individuals and Entities: A Comparative View' (1995) 2 *Tulsa Journal of Comparative and International La*w 187, 197, footnote 45.

[27] Elvin R Latty, 'The Corporate Entity as a Solvent of Legal Problems' (1936) 34 *Michigan Law Review* 597, 599. Note Lord Cooke, 'Corporate Identity' (1998) 15 *Company & Securities Law Journal* 160, 161 refers to Lord Halsbury's *Salomon* image of a company as 'a real thing' at 33 in his judgment and consequently ..it had a legal existence and if consequently the law attributed to it certain rights and liabilities in its constitution as a company it appears to me to follow as a consequence that it is impossible to deny the validity of the transactions into which it is entered'.

[28] See *Berkey v Third Ave Rye* 155 N.E. 58, 61 (N.Y. 1927).

[29] Samuel Stoljar *Groups and Entities: An Inquiry into Corporate Theory* (1973) 2.

[30] A S Schane, 'The Corporation as a Person: The Language of a Legal Fiction' (1987) 61 *Tulane Law Review* 563, '[Corporate personality doctrine] is one of the most enduring institutions of the law and one of the most widely accepted legal fictions'.

[31] 'Family Companies and Women's Proprietary' (1997) 11 *Australian Journal of Family Law* 26, 42.

[32] Spender was observing how the law solved problems in family companies, which normally allowed courts to fall back on the doctrine of separate entity, rather than considering that the company, particularly a family company, is essentially composed of family members with a common interest.

[33] Bryant Smith, 'Legal Personality' (1928) 37 *Yale Law Journal* 283.

> It is not the part of legal personality to dictate conclusions. To insist that because it has been decided that a corporation is a legal person for some purposes . . . is to make . . . corporate personality . . . a master rather than a servant, and to decide legal questions on irrelevant considerations without inquiry into their merits. Issues do not properly turn upon a name.

The last 200 years of commercial growth and inevitable litigation has mythologized the company form. A legal arrangement has become a body, with 'a will and mind, with organs, hands and brains'.[34] Others have sought to draw back from this bald separation, for instance Buckley LJ said:

> A corporation has neither body, parts nor passions. It cannot wear weapons nor serve in wars. It can be neither loyal nor disloyal. It cannot compass treason. It can be neither friend nor enemy. Apart from its corporators, it can have neither thoughts, wishes or intention, for it has no other mind than the minds of the corporators.[35]

Similarly Lord Chancellor Thurlow has said: 'Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?"'[36] noting that some would dispute this, by pointing to the fact that companies may have a corporate culture akin to a personality. [37] In 1250 AD, Pope Innocent IV is reputed to have forbidden the practice of excommunicating a corporation convicted of a crime; he reasoned that because a corporation had no soul, it could not lose it.[38]

Personalising the entity of the company in modern times moves the conception of the company from a company of persons to legal person known as a company is quite a shift in perception. A comprehensive development of how the company entity should be treated is yet to come - clearly parliament can direct that that be done. The issue of how different the corporate entity is to that of a human should be determined. The challenge is to formulate some flexible definition of the corporate entity in order to accommodate those differences

The company has never been considered as a body equivalent to that of a human

English law, including the church through canon law, began to develop the concept of a corporate entity or personae ficta and to operate as an incorporate person in what is often referred to as the corporation sole.[39] Whether the fictitious body of the corporate sole was actually a separate entity or an embryonic version[40] probably doesn't matter, the practical use of separate entities was now recognised, if not embedded in law. However, the church was not the only body which embraced the use of fictional entities, Henry de Bracton, an English jurist and chancellor of Exeter Cathedral in 1264, wrote of bodies 'politick' and incorporate in one of the first works on English law.[41] And so in the thirteenth and fourteenth centuries various corporate bodies began to develop, probably the most important being the guilds, which were descendants of the medieval guilds, originally formed to regulate the commercial activities of particular trades.[42] The guilds were permitted to gain a charter (a separate entity), followed by other bodies which claimed a separate entity and these included the counties, boroughs, hundreds, manors, chantries, deans and chapters, monasteries and even societies

[34] *Tesco Supermarkets Ltd v Nattrass* [1972] AC 154.
[35] *Continental Tyre and Rubber Co (GB) Ltd v Daimler Co. Ltd* [1915] 1 KB 893.
[36] This was referred to in regards to the company trading on a Sunday in contravention of the *Sunday Observance Act 1677* (UK) *Rolloswin Investments Ltd v Chromlit Portugal Cutelaris E Produtos Metalicos* S.A.R.L [1970] 1 WLR 912.
[37] *Model Criminal Code 1992* (Cth).
[38] Sheryl J Wragg, 'Corporate Homicide; Will Michigan Follow Suit' (1984) 62 *University of Detroit Law Review* 62, 67.
[39] A corporation consisting of a certain office (such as a bishop) which continues as a legal entity, regardless of the human holder of that office. Halsbury's Laws of Australia: Lexisnexis para [120-1110].
[40] Frederic William Maitland in *The Collected Papers of Frederic William Maitland*, HAL Fisher (ed), (1911) 210, 243 claims it was not a juristic person and possibly land could pass if the office was vacant.
[41] *De legibus et consuetudinibus Angliae* (On the Laws and Customs of England) reportedly the earliest attempt as a systematic treatment of the body of English law, he was an English jurist and writer, later Chancellor of Exeter Cathedral.
[42] R Scott, *Joint Stock Companies to 1720* (1912), Colin A Cook, *Corporation, Trust and Company* (1950).

of lawyers.[43] By the 1500s to the 1600s a company could be formed in the United Kingdom by royal charter, e.g. the Mineral and Battery Company 1568,[44] which was followed by a surge of unincorporated bodies claiming a type of corporate personality. In 1720 the *Bubble Act* (UK) was passed with the intention of preventing unincorporated joint stock bodies from claiming a corporate personality and to prevent them from trading their 'shares',[45] a piece of reactive legislation in response to a crisis, not dissimilar to modern times. Not that it stopped the promotion of unincorporated associations, which led Lord Eldon to declare that unincorporated associations who claimed a corporate personality committed an offence under common law: *Kinder v Taylor*.[46] This all led to the abolition of the Bubble Act in the *Bubble Act Repeal Act 1825* (UK). In 1844 there was the passing of the *Joint Stock Companies Act 1844* (UK), which gave the right (for the first time since the days of Republican Rome) for full, free and voluntary incorporation by mere registration rather than by charter or private act of parliament. After allowing limited liability in 1855 and 1856, parliament extended limited liability to members of registered joint stock companies (as distinct from limited companies) and a consequent increase in registrations then took place by joint stock companies. Registration as a company was taken as a right, a form of separate entity was created, but not one that was characterized as a human person.

Historical studies of Australian company law, which till the latter part of the 20th Century were essentially colonial and then state law,[47] shows that Australian jurisdictions generally followed the UK model.[48] Companies could be created as of right, without there being any thought as to their place in society, other than in order to facilitate a new economy that required investment and limited liability to encourage entrepreneurship, new commerce and industrialization.

What is piercing and why does it occur?

Piercing by the courts usually takes place where the courts are convinced that the company entity has been misused in some way;[49] particularly by shareholders improperly using the company entity to shield themselves from potential third party claims. Which is a significant withdrawal of a right, given that a prime reason for forming a company is to shield an operator or owner from liability.[50] This does not discount other reasons for the creation of a company such as the need to collectively accumulate capital, to minimise tax or to have a transferability of ownership which flows from having a separate legal entity. An alternative type of piercing is reverse piercing whereby the shareholders attempt to have the courts show they are not separate entities from the company e.g., to find that the shareholders are realistically the owners of company property.[51]

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[43] William Holdsworth, *A History of English Law* Vol VIII (2nd ed 1925) 469.

[44] The New River Company 1606 and the Hudson Bay Company 1670, to name but a few.

[45] *The Bubble Act 1720* (UK) attempted to stop persons claiming that their unincorporated association had corporate personality and to prevent them using existing charters for novel and unintended purposes.

[46] (1825) 3 KH Ch 68, see also *Van Sandau v Moore* (1826) 1 Russ 441.

[47] John Waugh, 'Company Law and the Crash of the 1980s in Victoria' (1992) 15 *UNSWLJ* 356,
358. Many of the original companies in Victoria were English companies though colonial legislation began to take over and companies could incorporate with the passing of the *Companies Statute 1864* (Vic) and its successor *Companies Act 1871* (Vic) later consolidated into the *Companies Act 1890* (Vic). Later followed by the *Companies Act 1896* (Vic).

[48] Rob McQueen, 'Limited Liability Company Legislation — The Australian Experience' (1991) 1 *Australian Journal of Corporate Law* 22 maps the evolution of company law in the Australian colonies. For the period 1901–1961 see McQueen R, 'An Examination of Australian Corporate Law and Regulation 1901–1961' (1992) 15 *UNSWLJ* 1.

[49] Young J, in *Pioneer Concrete Services Ltd v Yelnah Pty Ltd* (1986) 5 NSWLR 254, 264, said '[t]hat although whenever each individual company is formed a separate legal personality is created, courts will on occasions, look behind the legal personality to the real controllers'.

[50] Noting that some suggest that limited liability is only one factor considered by those setting up a company: Companies and Securities Advisory Committee, Corporate Groups, Final Report, May 2000, para 1.52: states that limited liability has certain economic goals, which they go on to list.

[51] *WorkCover Authority of NSW v Krcmar Engineering Pty Ltd* (Unreported, Industrial Relations Court of New South Wales, Fisher CJ, 18 May 1993). The defendant argued that as a $2 (now insolvent) company that it was really an individual's business. The defendant invited the court to look behind the veil and disregard the company entity. The court in this case did in fact hold it to be a private business and as such reduced the penalties under the *Occupational Health and Safety Act 1983* (NSW) to that of an individual. The court in its reasoning specifically looked behind the veil to find the reality of the company.

In addition to the courts developing their own doctrines for discarding the separation of entity, there are some limited instances whereby Parliament has passed laws specifically making individuals liable for proscribed actions, irrespective of foundation entity statements in company legislation. Apart from some specific sections in legislation[52] which remove the protection of the corporate entity, 'piercing' is basically considered to be a judicial technique whereby the courts have interpreted legislation establishing the creation of the company entity as unavailable to those who e.g., misuse the separation of entity protection, or where it is unfair to uphold the rigid separation. The fact that courts do this is interesting, in that it demonstrates a common law principle that courts are able to set aside the company entity under the universal Anglo system of law. This is a power derived by courts under the separation of powers, and in assuming the right to interpret the law they make law.

Australia's view of veil piercing could be summarised as one - an acceptance of the *Salomon* principle, two- a reluctance to pierce, three – actual piercing as the need arises, and four – no predictable set of principles by which the courts will or will not pierce.

The grounds for piercing the veil in British law seems to have developed as a set of exceptions, created by different courts at different times, with some periods showing a greater propensity to pierce, but without establishing any firm grounds when a court might pierce. The body of law on piercing is therefore confusing and consists of a series of cases rather principles, though some suggest that this is a strength e.g., 'The jurisdiction to pierce the veil of corporateness gives the courts a considerable degree of discretion and enables them to do justice and to decide individual cases in accordance with equitable considerations'.[53] The downside of this is of course the unpredictability of veil piercing.

Smadar Ottolenghi[54] was a writer whose work demonstrates a more flexible idea of piercing the veil and refers to a number of different possibilities, such as reaching in, or outside, of the company entity in the event that a court believes there is unfairness or inequity occurring, while attempting to preserve the 'sanctity' of separate entity. Ottolenghi basically refers to the idea of the corporate veil as a type of company enclosure allowing outsiders to:

- Peep behind the veil: to find who are the actual shareholders or management without necessarily disregarding the company entity;
- Extend the veil: to find who is truly within the ambit of the company entity, i.e. some individuals use the company to cover their own illegal activities;
- Ignore the veil: disallow the company entity where it was fundamentally established for fraudulent purposes;
- Penetrate the veil: to find the shareholders or owners who should be personally liable for the company's actions.

Piercing as a doctrine or process has no set definition and can mean many things, just as the company format itself has various definitions and meanings. The result is that piercing is an indefinite concept, and in fact unpredictable, except perhaps where there is statutory piercing. Note there is a question as to whether statutory piercing is really piercing or in fact regulation.

Many jurisdictions of the world now recognise that it is both possible and at times necessary to pierce the veil of incorporation, but the doctrine has developed jurisprudentially as an erratic and uncertain doctrine without any real clear direction.[55] An observation by Frank Easterbrook and Daniel Fischel[56] suggests that:

[52] These include taxation law, mining law, occupational health and safety law, environmental law and various other legislation which hold an individual personally liable and without the protection of the corporate entity.
[53] Geoffrey Morse, *Palmer's Company Law* (1992), 2.159.
[54] 'From Peeping Behind the Corporate Veil to Ignoring it Completely' (1990) 53 *Modern Law Review* 338.
[55] Stephen Bainbridge says that piercing is on a factual basis and is therefore unpredictable and random and decided case by case: 'Abolishing Veil Piercing' (2001) 26 *Journal of Corporation Law* 479.
[56] *Limited Liability and the Corporation* (1991) 89.

> …piercing seems to happen freakishly. Like lightning, it is rare, severe, and unprincipled. There is a consensus that the whole area of limited liability, and conversely of piercing the corporate veil, is among the most confusing in corporate law.

The whole situation of piercing is made even harder to grasp by the fact that the name of the concept and any discussion dealing with the disregard of the company entity is basically conducted in metaphors. Easterbrook and Fischel[57] go on to cite with approval a quote in Phillip Blumberg[58] where the legal analysis related to piercing the veil in the US was:

> …jurisprudence by metaphor or epithet. It does not contribute to legal understanding because it is an intellectual construct, divorced from business realities. The metaphors are no more than conclusory terms, affording little understanding of the considerations and policies underlying the court's actions and little help in predicting results in future cases….As a result, we are faced with hundreds of decisions that are irreconcilable and not entirely comprehensible. Few areas of the law have been so sharply criticised by commentators.

Much is therefore left to the courts to determine the whole issue of the purpose of a company, who owns the property of the company and the whole issue of the separateness of company.[59]
The concept of corporate entity therefore remains undefined in any conclusive way both at common law and under Australian legislation. The entity of the company has therefore been equated to that of a person for the purposes of understanding the company and its separation from its owners and controllers. This raises the question of whether a company should be considered as a unique entity and thereby removing the confusion of trying to explain the company as if it were a natural person.

The company's existence as right, concession or privilege

A consideration of the theory of the corporation discloses a plethora of company models which explain what a company's role, or at least what it should be, within our society, and in fact do much to explain the varied perceptions held by the observers of companies.

The most basic of theories is probably that of a contractarian model which demands the legal system uphold the primacy of the individual by creating and facilitating the company as part of contractual relationships. A good example might be Milton Friedman who wrote, 'There is one and only one social responsibility of business-to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud'.[60] Such a stance promotes economic efficiency for contracting parties such as shareholders, without considering the fall out of social costs and inequality. This is a utilitarian model which distinguishes a company as a private body and not subject to state control,[61] except for its internal and external contractual relations. Variations of this stance include the perception of the company as a fiction (holding an aggregation of individuals),[62] a

[57] Frank H. Easterbrook & Daniel R. Fischel, 'Limited Liability and the Corporation' (1985) 52 *University of Chicago Law Review* 89.
[58] Phillip Blumberg, *The Law of Corporate Groups: Procedural Problems in the Law of Parent and Subsidiary Corporations* (1985), no page reference given.
[59] See Parker J in *KT & T Developments Pty Ltd v Tay* (unreported, Supreme Court of Western Australia, 23 January 1995), he said: 'The selection of an incorporated entity as the vehicle for that endeavour brings with it the consequences of the vehicle. The most significant of those consequences…are that the company has a separate legal existence from its shareholders and that the ownership of shares in the company, while potentially valuable, does not give the shareholder any proprietary interest in the property of the company….' See Latham CJ in *The King v Portus; Ex parte Federated Clerks Union of Australia* (1949) 79 CLR 42, who said that: 'The company…is a distinct person from its shareholders. The shareholders are not liable to creditors for the debts of the company. The shareholders do not own the property of the company…'
[60] Friedman M 'The Social Responsibility of Business is to Increase its Profits' *New York Time Magazine* 13 September 1990, 32.
[61] See the discussion in David Millon 'Theories of the Corporation' (1990) *Duke Law Journal* 201 at 211.
[62] Sir John Salmond in Jurisprudence at 342-3 op cit '…..Although corporations are fictitious person, the acts and interests, rights and liabilities, attributed to them by the law are those of real or natural person, for otherwise the law of corporations would be destitute of any relation to actual fact and of any serious purpose.'

mechanistic view of company law, and a laissez faire view without any notion of what social responsibilities such an entity should have.

At the other end of the theoretical spectrum is to hold the company as liable to all its stakeholders, a communitarian stance which means that a company has social obligations to more than just its shareholders. An extension of a social perception of the company is that the company is considered a privilege or concession by the state, and consequently must act appropriately in relation to those with whom it interacts, and that is more than just complying with contractual obligations, it means that it must act ethically, prudently and appropriately to maximize all social goals, not just economic ones.[63]

A company and its operators should not be permitted to operate with unsafe work practices, using phoenixing to defeat creditors[64] or destroying documents to defeat legal actions.[65] Consider for instance: *Environmental Protection Authority v Caltex Refining Co Pty Ltd*[66] where Mason CJ and Toohey J cited the US case *Hale v Henkel*[67] to justify not allowing the company the privilege against self-incrimination. Justice Brown in that case had said:

> [T]he corporation is a creature of the State. It is presume to be incorporated for the public. It receives certain privileges and franchises, and holds them subject to laws of the State and the limitations of its charter. Its powers are limited by law.'

A similar theory is the realist theory which ascribes to the corporation the reality of the company as a 'real' person with a mind and a will, expressed through 'organs' of the company.[68] Rather than a company being prescribed as a convenient fiction for legal activities, a company is viewed as the group of individuals who form and run the company, consequently the will and mind of the company can be formulated from the 'will' of the humans that make up the company. The persons bringing the company into existence act with a common purpose, their actions will make the company liable – just like any other individual.

The challenge in referring to theory is that there is no one size fits all, companies come in different sizes and are created for different purposes; each company is unique, though nevertheless the same legislation and common law applies to all. One could argue the following:

1. That there is no conceptual framework for companies in Australia, rather an ad hoc and piecemeal bundle of rules and regulations under which a company forms. The natural conclusion might be that Australian law could do with some statement about what a company is and should be. However, if a company claims rights similar to a human, then should it not be subject to the same social, moral and ethical requirements placed on natural persons?
2. That the existing Australian framework, while not stating up front any absolutes in terms of perceptions of a company or official theory, is a product of a theory whether it be laissez faire or perhaps some form individualism which is tempered by a necessary intervention of the state when required. Perhaps the conclusion from this is that the company structure is working as it is and will be modified when and if it is necessary according to current social mores.
3. That company law provides a framework in which the prevailing theory or more crudely cultural and social aims will come to the fore as the judiciary makes its decisions.[69] This approach suggests that law is not static but is subject to current theory, even indirectly, whereby the judiciary in its wisdom will shape the theory of companies in Australia – just like it could be argued, it has done so in other countries.[70]

[63] Parker, D. The undercapitalization of a company: Can this be the basis for piercing the corporate veil? Australasian Law Teachers Association – ALTA 2006 Refereed Conference Papers.
[64] Phoenixing is liquidation of a bankrupt company after transferring assets to a new company.
[65] *Crimes (Document Destruction) Act 2006* (Vic).
[66] (1994) 12 ACSR 452.
[67] 201 US 43v.
[68] 7th ed Sweet & Maxwell pp342-3.
[69] See *Statewide Tobacco Services Ltd v Morley* (1990)2 ACSR 405 and alternatively *Glavanics v Brunninghausen* (1996) 19 ACSR 543.
[70] The UK and US in particular.

Conclusion

The purpose of the doctrine of piercing is to hold those who operate under the protection of the separate entity of the company as liable for their personal actions, an action which can take place by a court disregarding the corporate entity, or where statute determines specific personal liability. Piercing the veil has occurred since legislation creating companies was first passed, it has also been refused by courts in many instances even though a refusal to pierce left an unfair situation unresolved. A refusal to pierce, even where it may have resolved an inequity, is a stance by a court to preserve the ideal of the company as a separate legal entity. The willingness or reluctance of courts to pierce has not slowed the use of companies, nor led to any particular outcry against the use of separate entity by companies, though by any stretch the growth of company regulation as an alternative means of piercing is self-evident.

The use of a doctrine such as piercing is increasingly irrelevant, particularly as companies, and their operators are becoming more and more regulated by a variety of legislation. To hold someone liable for their actions under the umbrella of the company is self-evidently demonstrated by the prolific numbers of cases litigated or prosecuted, where with or without a reference to piercing, individuals can be held liable for their actions. The mythology of piercing could be on a par with the mythology of the protection of the separate legal entity of a company.

If piercing occurs either by a court disregarding the entity of the company under common law, or by statute, this is in essence a regulation of the company, usually for the purpose of ensuring the company's operators comply with appropriate ethical standards as determined by community and business practice. If then piercing is essentially regulation, how can this means of regulation be enhanced without resorting to the fuzzy undefined concept of piercing?

One means of ensuring appropriate behaviour by those within a company, by self-regulation for fear of prosecution, or by compliance with accepted principles of good business, is to just leave the law to develop as it has. Indeed, statute has grown incrementally, if not haphazardly, usually as a response to some crisis or disaster.[71] Legislation such as the need to retain documents within an organisation, even if potentially detrimental, the Occupational Health and Safety provisions placed on management, enhancement of directors duties and consequent liabilities, all point to increasing sensitivity to operators of companies to actually ensure that the company, and they themselves comply with appropriate community standards.

Under a fuzzy law concept, the less said the less problem there is in interpreting what is actually expected from the operators of a company. It would seem however the less stated is a bit at odds with currently 'nothing stated'. A glance at companies legislation from Australia, Canada, the UK and New Zealand shows no statement whatsoever as to the nature of a company, except for the allusion to the company as a separate entity. With one exception, i.e. s 7 (2) in the UK Companies Act there is a statement that a company must not be formed for an unlawful purpose; an interesting statement which might be the basis of bringing an action against those forming a company to facilitate phoenix activity or to promote some kind of fraud.

One means of possibly enhancing appropriate behaviour is to actually have some statement in company legislation that sets some form of benchmark as to 'what is a company?' and furthermore what is expected of management. This follows the idea of a company as either a privilege or a concession, granted in response to a standard of expected behaviour from management.

A legislative statement as to company might be: 'A company is the legal representation of an individual or association of individuals, members, officers, managers and employees. That legal representation is considered under law as a legal entity as per the provisions of this legislation. The formation and operation of a company must be for a proper purpose according to community

[71] See CLERP 9 and the new provisions relating to auditors after the HIH and similar disasters.

standards in addition to regulation imposed by corporate legislation. The controllers of a company are expected to operate according to appropriate social standards'. The statement targets 'controllers' of a company, which might in some instances be the shareholders who take on that role, whereas non-involved shareholders would not be held liable. The 18th Century companies evolved out of a particular stage in history, similarly the 21st Century companies sit in a different environmental complexity, and Australian law appears quite passive in its perception of what a company should be.

Fact, Fallacy and Failure in Small Business Governance

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Significance

Small businesses comprise almost all of the businesses in Australia but less than 30% are incorporated. Collectively small businesses are the largest employers in our country.

Fact

A small business originates from an idea in some one's mind and grows from the development of that idea. Only after it has taken hold, been accepted and started to grow is it any more than the thinking of an individual. Governance therefore is entirely in the mind of the individual. The individual is the business. Governance reflects the personal beliefs and societal relationships of that individual.

Fallacy

It is a fallacy to believe that most or even many small businesses have any systematic approach to governance. Governance is most often thought of as control of the enterprise and the reality is that the person with the cheque book is the Governor.

As enterprises grow so does the need for processes to manage the growth and performance. This is the start of governance practices and most often it will be around managing the finances and payment procedure, employment practice and workplace health and safety. Many other activities will just proceed as usual because that is how they have always been done. A good descriptor would be "management by exception" meaning that when something has gone wrong the process for doing it right will be written down and become part of the governance practice of the organisation.

The need for some external form of accreditation, usually an Australian Standard or the opportunity to tender for a government contract hastens the development process of governance activity.

Failure

Governance failure finally emerges when the business owner decides it is time to sell or retire and is effectively forced to sell the business. The question then arises as to what is there to sell. If all the process, application and control is in the mind of the individual ie "the individual is the business" then there is nothing to sell. The progressive development of governance practices which guide and control the business ensures that it has longevity and thus with intrinsic value becomes a saleable asset. It has become a business outside of the individual.

Failure to achieve this is clearly a failure in small business governance. Sadly, this is the norm.

Exploring Business Perceptions of the Compliance Costs of Regulation

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Abstract

The compliance costs of regulation borne by businesses operating in Australia are of growing concern, particularly the disproportionate impact upon small business. This paper uses correspondence analysis on a survey of businesses in NSW and Victoria to further investigate the links between the characteristics of businesses such as firm size, difficulty with various types of regulation and external advice. The main findings of this paper are that although there is a positive relationship between firm size and difficulty complying with government regulation, the level of difficulty seems to have a minimum level even for the very small firms. Furthermore it appears that certain types of external advice, particularly advice from accountants, may operate to significantly reduce the difficulty firms have maintaining compliance.

Key Words

Regulation, Compliance cost, Firm size, Small business

Introduction

Small businesses are very important to the Australian economy. They account for over 47 percent of all employment, over 32 percent of wages and salaries, over 30 percent of sales and service income, over 42 percent of operating profit (before tax) and over 35 percent of industry value added (ABS 2012).

Costs of regulation can be conveniently divided into direct costs, allocative inefficiency and compliance costs (Lewis et al 2014). Compliance costs are the focus of this study. Compliance costs fall into three general categories. The first relates to becoming aware of regulations which must be abided by. This might involve hiring particular expertise (accountants, lawyers, for example), taking part in training or having to devote time by owners or staff in educating themselves in what exactly is required under legislation and the costs of non-compliance. The second relates to the costs of actually abiding by the regulation. For instance, health and safety regulation might prescribe the purchase of special equipment such as safety guards, helmets, wash basins, first aid kits etc. The third category of costs relates to demonstrating compliance with legislation. This mostly involves record keeping, which increasingly involves computer packages but is often referred to as paperwork. The boundary between actually complying with legislation and demonstrating compliance can be somewhat blurred. The costs include hiring outside professional help, devoting staff to compliance related activities or, quite likely for small businesses, devoting the owner's own time.

Background

See Lewis et al. (2014) provide a broad overview of the regulatory landscape for small business, definitions of compliance costs and small business. Here the focus is on the costs associated with regulation that is over and above the normal day to day running cost of a business, particularly if the regulation imposes costs upon those being regulated that are unnecessary. Such costs

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have been defined by the Productivity Commission (2007) as being a regulatory burden and include terms found in the literature, which are used interchangeably, such as compliance costs, administrative costs and regulatory costs (Chittenden et al 2002).

The costs of compliance to business are considered to be substantial, although quantifying these burdens has proved difficult (Banks 2006). Conservative estimates put compliance costs to the Australian economy at tens of billions of dollars annually (Banks 2006). The costs of regulation include time, paperwork, capital outlays, and deflection from core business activities. From the submissions sent to the Productivity Commission it is estimated that compliance can take up to 25 percent of the time of senior management and boards of large companies' time (Banks 2006).

This paper concentrates on small businesses and fills a gap in the literature by providing quantification of the costs of regulation in terms of both time and money. In this paper we use a recent survey of small businesses in Australia to explore, using correspondence analysis, the perceptions of these businesses about the relationship between sources of advice and cost of compliance with Government regulation.

Methodology

In this paper we are concerned with the association between the various categorical variables of a survey of businesses regarding their views on the cost of compliance with government regulation. For example the association between the size of the firm (of which there are five size categories) and the dollars they spend meeting government compliance (of which there are five different categories of expenditure). The Developing a Responsive Regulatory System (DARRS) survey was conducted in 2010 in New South Wales and Victoria. From the survey there were 391 valid responses to various questions relating to business activity and the costs associated with being compliant with government regulation. A detailed description of the survey is provided in Lewis et al. (2014).

For this type of study correspondence analysis is well suited. Correspondence analysis is a way of analysing a two-way table of data that was developed by French statisticians, most notably Benzecri: see, for example, Benzecri (1992). The standard reference in English as a first language is Greenacre (1984). Correspondence analysis compares the relative row and column distributions of a two way table. Take for example firm size and dollars spent meeting compliance. If firm size was tabulated vertically and dollars spent horizontally, the relative row distribution would show, for example, for the firm size between 1 and 5 people what proportion of those firms spent less than $1,000, between $1,000 and $5,000, between $6,000 and $10,000 etc. Similarly, the relative column distribution would show, for example, for the dollars spent less than $1,000 in what proportion of those that spent less than $1,000 were the firm size less than 1 person, between 1 and 5 people etc. Correspondence analysis then seeks to optimise the correlation between row and column scores by extracting dimensions. The first dimension contains the optimised scores and the second and subsequent dimensions maximize the correlation between row and column scores, subject to ensuring that the second and subsequent dimensions do not explain any of the variance between the categorical variables already captured in the first dimension. This constraint makes the explanatory power of all the dimensions cumulative and ensures that the first dimension is the primary dimension in which most of the variance between the categorical variables is captured.

Correspondence analysis has been used successfully in the medical sciences (Greenacre 1992), environmental sciences (Digby and Kempton 1988) as well as the social sciences (Blasius and Thiessen 2001). Greenacre and Hastie (1987) explain how to interpret three aspects of a correspondence analysis plot. Observed distances between the row points on the plot are approximate Euclidean distances weighted by the proportion of observations in each row. Thus points that are close correspond to row categories that behave in a similar way. On the other hand, observed distances between column points are not strictly distances. Points that are close correspond to column categories that behave in a similar way, but no distances can be attached to this interpretation. Finally, there is also a geometric relationship between the row and column points on the plot. Row points that

are close to particular column points correspond to rows that are weighted heavily on those particular columns.

An extension of correspondence analysis, multiple correspondence analysis, can examine the relationship between more than two categorical variables. For a description of multiple correspondence analysis refer to Greenacare and Blasius (2006). Here we use both correspondence analysis and multiple correspondence analysis.

For the purpose of allowing greater ease with which the results can be interpreted, a detrending technique has been applied. For a number of the plots shown here the original results took a horseshoe-like formation. Digbyand Kempton (1987) note that a horseshoe shape of many correspondence analysis plots is a common feature that is a result of the method of derivation of scores. Straightening or detrending the horseshoe makes identifying the axis more straight forward. Although there are various methods for detrending, here we use polynomials to create a line that best fits the results of the correspondence and multiple correspondence analysis due to the improved accuracy noted by Ter Braak and Prentice (1988). The correspondence analysis was carried out in SAS and graphs were drawn in R (R Core Team 2014).

Applications of correspondence analysis to survey data can be found in fields as diverse as tourism (Beldona et al. 2005) and information systems (Berthon et al. 2001). BERR (2008) uses multiple correspondence analysis to visualise tables of business opinions (ranging from strongly disagree to strongly agree) and 15 core regulation questions. The correspondence analysis revealed four clusters, three of which were interpretable: regulatory environment, market environment and business operations.

Results

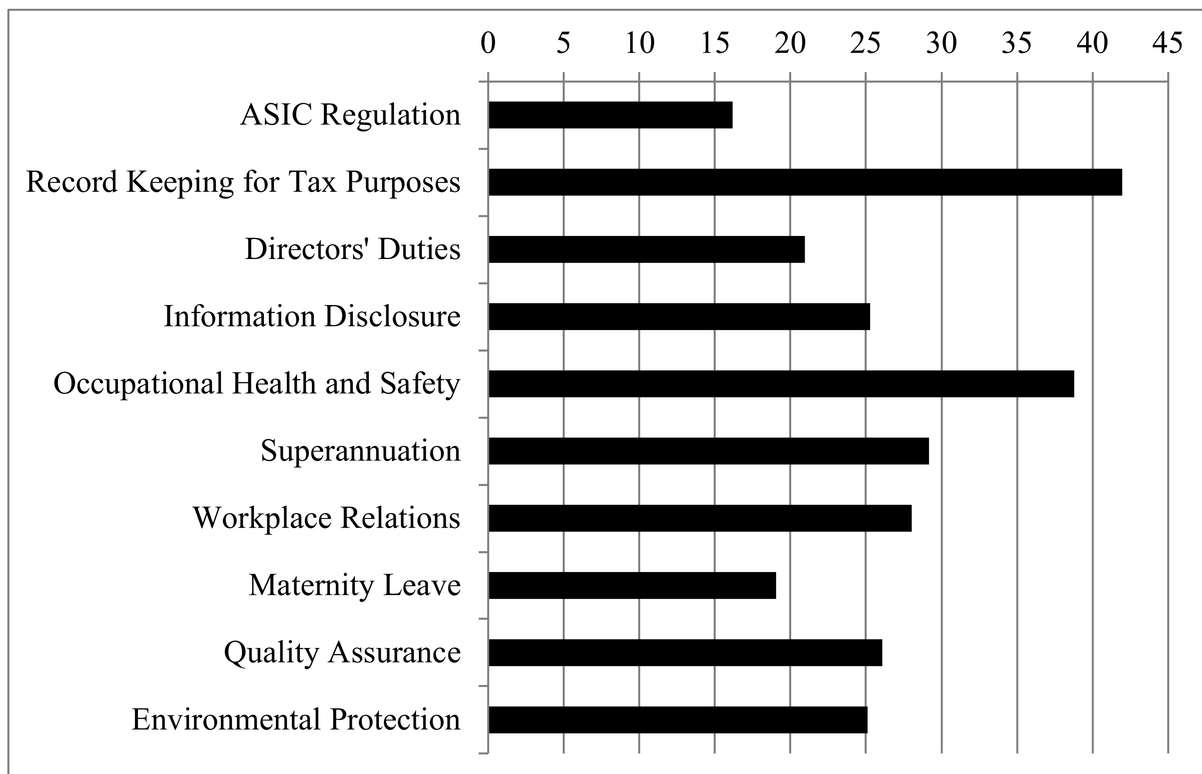
In the survey respondents were asked to rate the difficulty they have had with respect to a number of areas of regulation on a scale of 1 not difficult at all through to 5 most difficult. Here if a respondent rated a regulatory issue as either 4 or 5 this has been taken to mean the respondent has had difficulty maintaining compliance with this particular issue.

The results are structured as follows. A correspondence analysis is carried out on the two-way tables showing compliance difficulty for each regulation in the rows and firm characteristics (size, days spent on compliance and dollars spent on compliance) in the columns. Two dimensions were extracted. Scores for each row and column category were plotted in Figures 2 - 4. Figure 5 is then a visual summary of three firm characteristics (size, days and dollars as just described). The final results are correspondence analyses on the two-way tables showing for each regulation, source of advice in the rows and difficulty in the columns. Two dimensions were extracted. Scores for each row and column category were plotted in Figures 6 – 9.

An important step when exploring further into business perceptions with compliance difficulty is to get a relative sense of which regulations entail the greatest problems. However, much of the literature relating to the cost of compliance is focused upon the burden of complying with taxation regulation or looking at individual regulation types without offering a relative sense of where the greatest issues are perceived. We would expect to see then, that for firms in our sample, taxation compliance or in this case record keeping for tax purposes to be relatively more troublesome than other types of regulation.

Figure 1 shows the percentage of firms in the sample that have had difficulty with compliance by regulation type.

Figure 1 Compliance Difficulty by Regulation Type, percent of businesseses.



Clearly the greatest issues relate to recording keeping for tax purposes, with 42 percent of business having trouble, and occupational health and safety, with 39 percent of businesses finding it difficult to comply with. On record keeping, one respondent commented

"Taxation law and compliance [is] difficult to follow as I am not a professor on taxation law - and neither are the 'helpful' folk who take calls for the Tax Office (they are all subject to changing their minds, that is not what I meant or I will have to seek someone else's advice)".

On Occupational Health and Safety (OH&S), another said that

"OH&S [is] very hard to proactively determine level of satisfactory compliance ('paper trail' measurement with considerable cost/workload too often applied/relied on, and retrospectively)".

Other regulation types such as superannuation, workplace relations, information disclosure, quality assurance, environmental protection and directors' duties had a significant proportion of firms in the sample reporting difficulty with compliance. Maternity leave and ASIC regulation appears to be the least troublesome of all the regulation types with only 16 percent and 14 percent of firms within the sample reporting problems respectively.

Figure 2 Compliance Difficulty by Cost of Compliance ($)

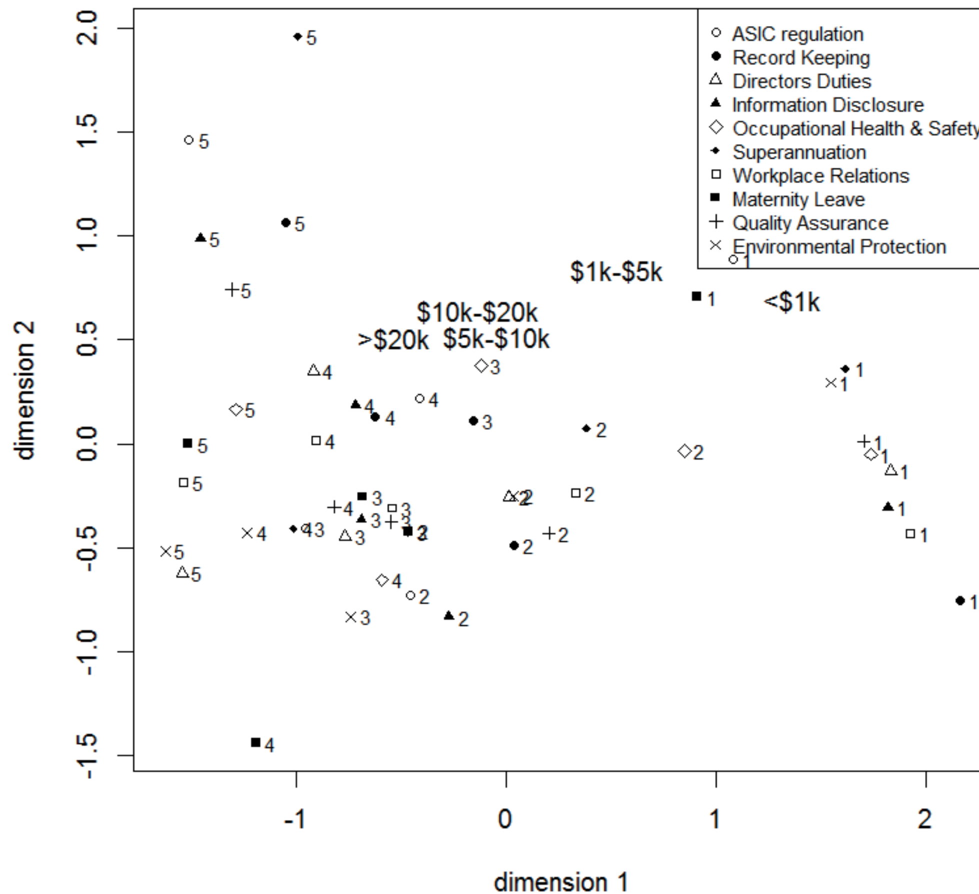


Figure 2 shows the compliance difficulty of various regulations (see legend) by cost of compliance (dollar figures on the graph with $1k = $1000). The questions asked in the survey of each regulation were 'how would you rate the difficulty caused by this issue (1=not difficult at all, 5=most difficult)' and 'how much do you spend on compliance per annum (<$1k, $1k-$5k, $5k-$10k, $10k-$20k, >$20k)?'.

The level of difficulty decreases from left to right across the graph, as does the dollar figure. Because of the detrending technique applied here, the vertical position of points is not interpretable. The proximity of the points labelled 1 and the dollar figure <$1k shows that firms who don't spend much don't perceive that they have very many compliance problems. Some businesses may be using strategies to reduce costs despite difficulties – for instance the respondent who said

"I complete administration after hours (I work full time) to cut expenses of wages etc of book keepers."

Similarly, the proximity of the points labelled 4 and 5 and the dollar figure >$20k confirms the expected outcomes that firms who do spend a lot perceive that they find compliance very difficult. There is no clear pattern of behaviour amongst the ten regulations, as the points for each regulation are scattered fairly randomly in the plot. Comments from respondents tended to be general when relating cost to regulation, for example "the significant burden created by regulatory cost … largely does not add value" .

Figure 3 Compliance Difficulty by Cost of Compliance (Days)

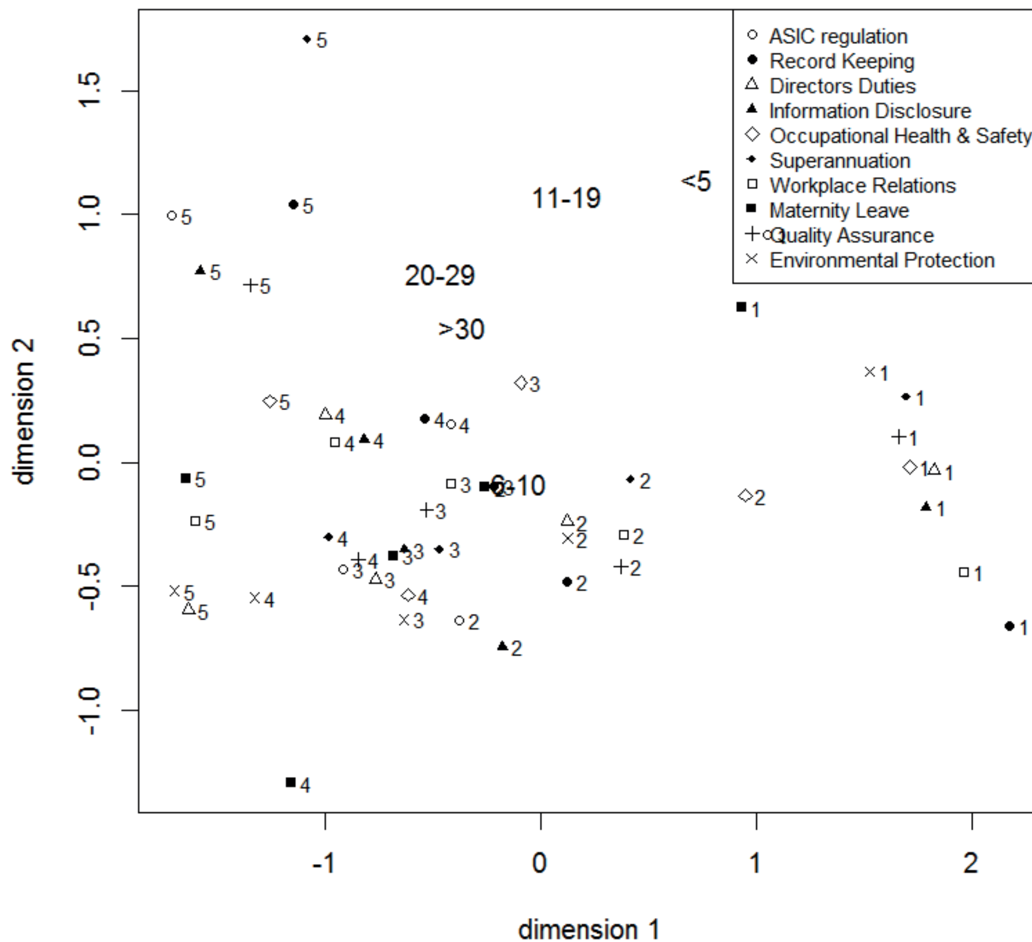


Figure 3 shows the compliance difficulty (1=not difficult at all, 5=most difficult) of various regulations (see legend) by cost of compliance (in days i.e. <5, 6-10, 11-19, 20-29, >30).

The level of difficulty decreases from left to right across the graph. The days tend to decrease as well, but the pattern is not as strong as the dollar figure; it is probably easier for businesses owners to know or guess dollar amounts than time amounts. The proximity of the points labelled 1 and the days <5 shows that firms who don't spend much time don't perceive that they have very many compliance problems. Similarly, the proximity of the points labelled 4 and 5 and the 20-29 and >30 days confirms the expected outcomes that firms who do spend a lot of time perceive that they find compliance very difficult. There is no clear pattern of behaviour among the ten regulations, as the points for each regulation are scattered fairly randomly in the plot.

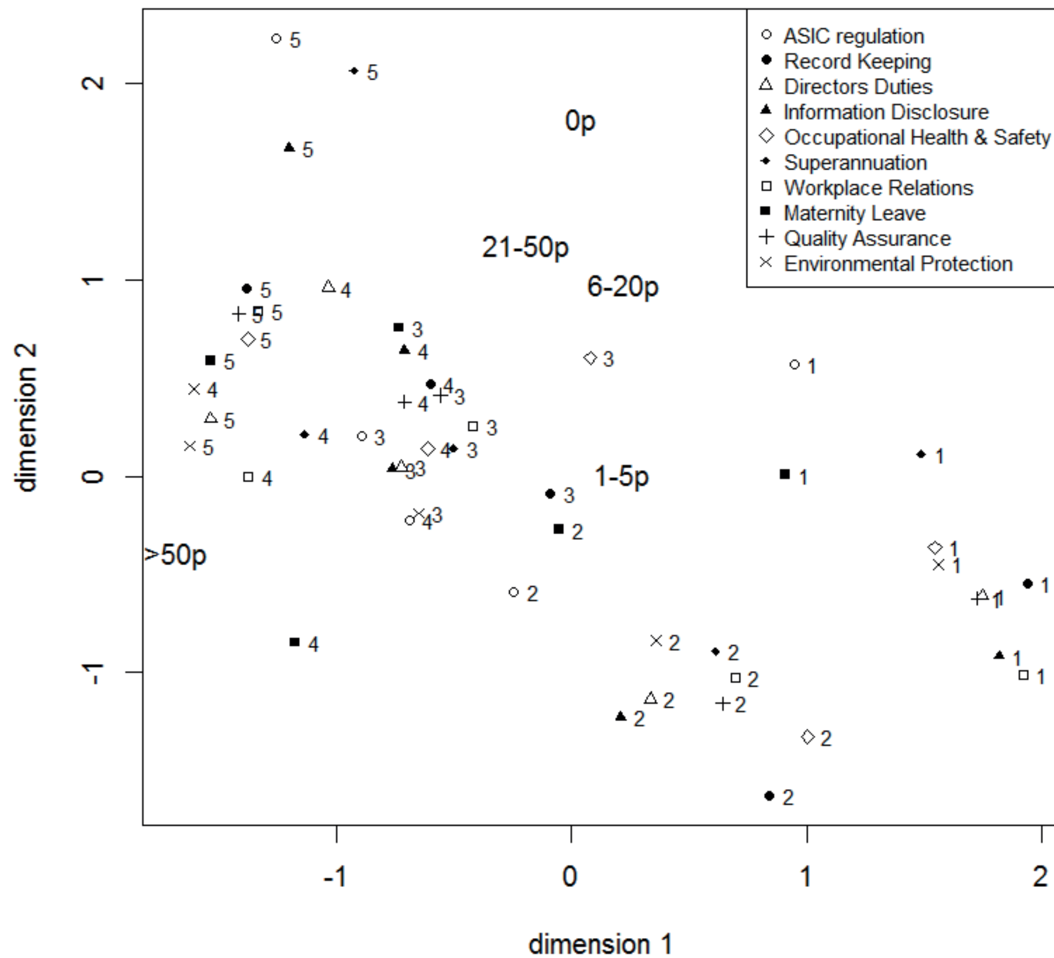
Only two regulation types were mentioned by respondents, one who said that

"Reporting for Occupational Health and Safety is extremely onerous and time consuming"

and another who said that

"Taxes cost for … staff time".

Figure 4 Type of Compliance Difficulty by Firm Size



Another area of the literature dealing with the cost of compliance relates to the size of the firm. Overwhelming evidence suggests that there is a disproportionate burden upon smaller businesses. One might expect smaller firms to have less regulation to comply with given much of the regulation deals with employees such as superannuation or workplace relations etc. On the other hand , small businesses do not have the advantage of economies of scale in administration that larger firms have.

Figure 5: Cost of compliance (days and dollars) by firm size

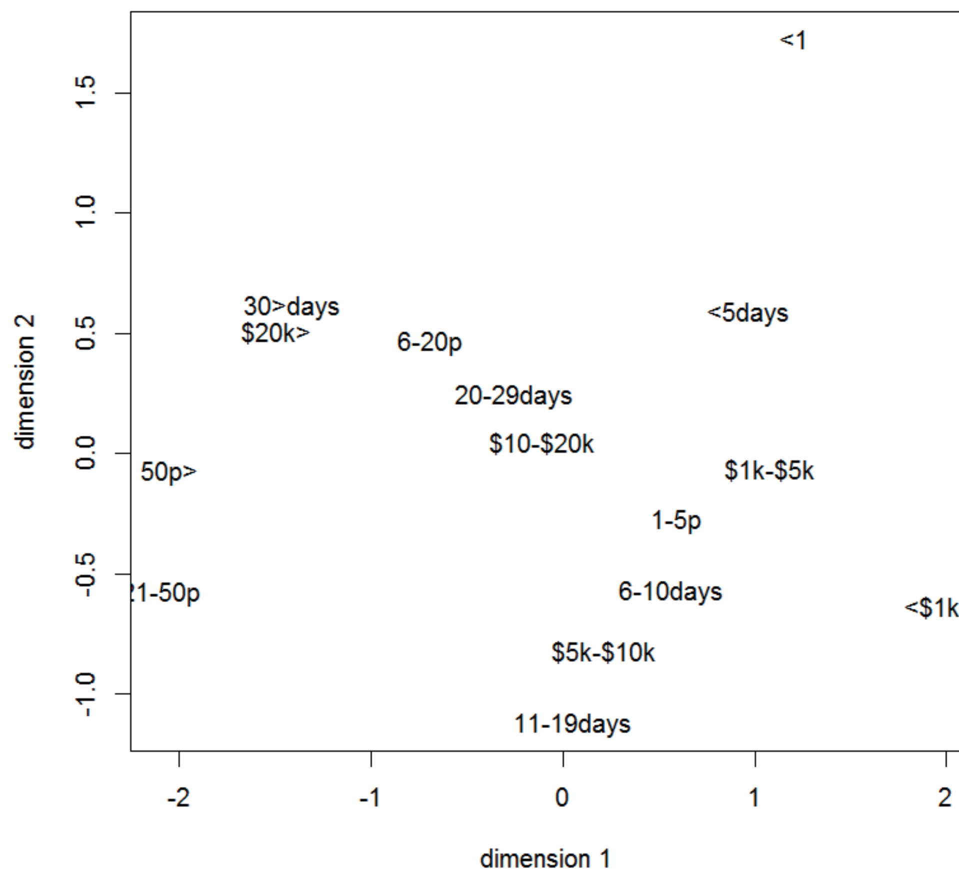


Figure 5 shows the cost of compliance (in days i.e. <5, 6-10, 11-19, 20-29, >30 and dollars i.e. (<$1k, $1k-$5k, $5k-$10k, $10k-$20k, >$20k) by firm size (<1, 1-5, 6-20,2 1-50, >50 employees).

The size of the firm overall (in terms of days, dollars and employees) decreases from left to right across the graph. The proximity of the points labelled >30 days, >50 employees and >$20k suggests that larger firms spend more on compliance in time as well as money. Similarly, the proximity of the points labelled 20-29 days, 10-$20k and 6-20 employees suggests that middle-sized forms spend a middle-sized amount on compliance. The interesting spread around time and money for the smallest firms suggests that there is much more variation in the way small firms spend time and money on compliance. However, generally it appears to show evidence of a disproportionate burden of compliance upon small businesses. It seems there is little difference in the level of difficulty complying with government regulation for firm sizes up to and including 21 to 50 people. For firm sizes over and above 50 people, however, the difficulty increases considerably.

For some, small firm size is an advantage:

“Being a very small business we do not have a lot of the regulatory issues which major companies may encounter.”

But not all would agree:

"A one man band ensuring everything complies."

Some respondents mentioned the shift of certain regulatory responsibility from government to business, and noted that being small increases the impact of this trend. Three regulations were mentioned by respondents:

"Tax - government using small business to collect tax for them & not reimbursed for this";

"Maternity leave is yet another service that government is getting small business to do on their behalf";

and

"Occupational health & safety regulations that are not workable in small businesses ..."

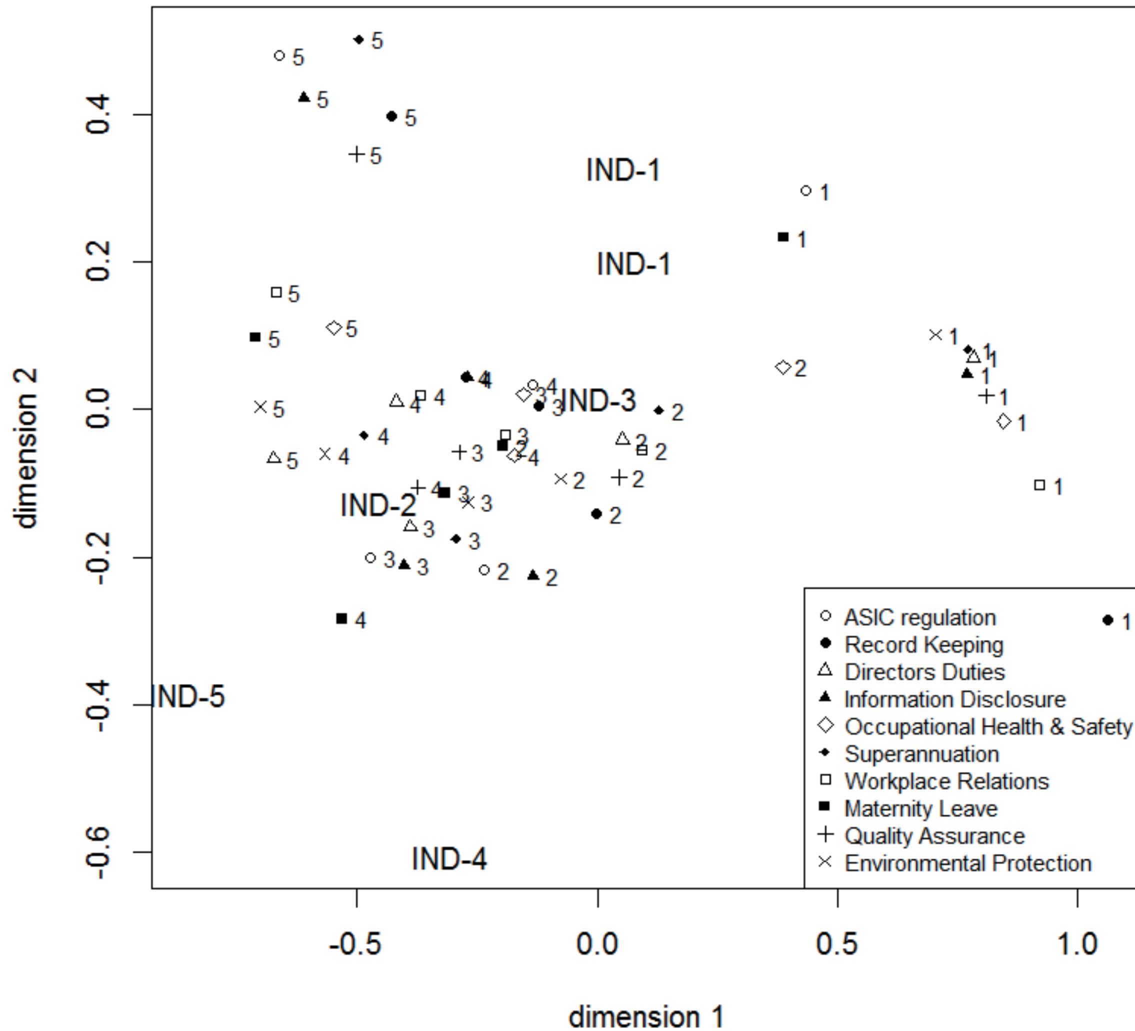
Sources of Advice

One tool that businesses use to assist them with understanding government regulation is external advice. The Small Business Deregulation Task Force (1996) found that, on average, of the total costs incurred by small businesses keeping compliant nearly half went on external advice. It may be of interest then to investigate which type of advice is associated with easing the burden of compliance. Additionally it could also be interesting to investigate if firms perceive government advice to be useful or not. Given the discussion in the literature relating to the burden of taxation compliance and the results previously shown in Figure 1, which pointed to record keeping for tax purposes being the greatest issue for businesses, we would expect to see accountants making the greatest positive impact. If a type of advice is effective at easing the burden of compliance we might expect to see higher levels of expenditure on advice associated with lower levels of compliance difficulty for the various types of regulation. Although these figures only show the association between various categorical variables, it would be most unusual, although not implausible, for greater advice expenditure to cause greater compliance difficulty. Therefore we might assume, on average, that the direction of causation is from compliance difficulty to advice expenditure.

Our survey looked at four types of advice which included advice from industry, lawyers, accountants, and government. The question asked in the survey for each type of advice was 'what is the proportion of your expenditure on each source of advice?' and 'how would you rate the difficulty caused by the following issues (1=not difficult at all, 5=most difficult). The following four figures look at the association between these various types of advice and the difficulty complying with various types of government regulation.

Figure 6 shows the association between the cost of compliance and expenditure on industry advice.

Figure 6 Compliance Difficulty by Industry Advice



It appears that there is an association between an increase in expenditure on industry advice and an increase in the level of difficulty with various types of regulation. However, the highest level of expenditure, greater than 25 percent, is associated with lower levels of compliance difficulty. This is, perhaps, some evidence that at relatively high levels of expenditure, industry advice can have a considerable impact on easing the difficulty of compliance. However, this suggests that the level of expenditure on industry advice is positively associated with, or may be caused by, the level of compliance difficulty. There seems to be a threshold in compliance difficulty (mostly easy) below which advice from industry is not sought. This implies that if the level of compliance difficulty can be reduced, through policy reform, to below this threshold, then expenditure on industry advice for purposes of regulatory compliance will, in large part, be unnecessary.

Figure 7 Compliance Difficulty by Lawyer's Advice

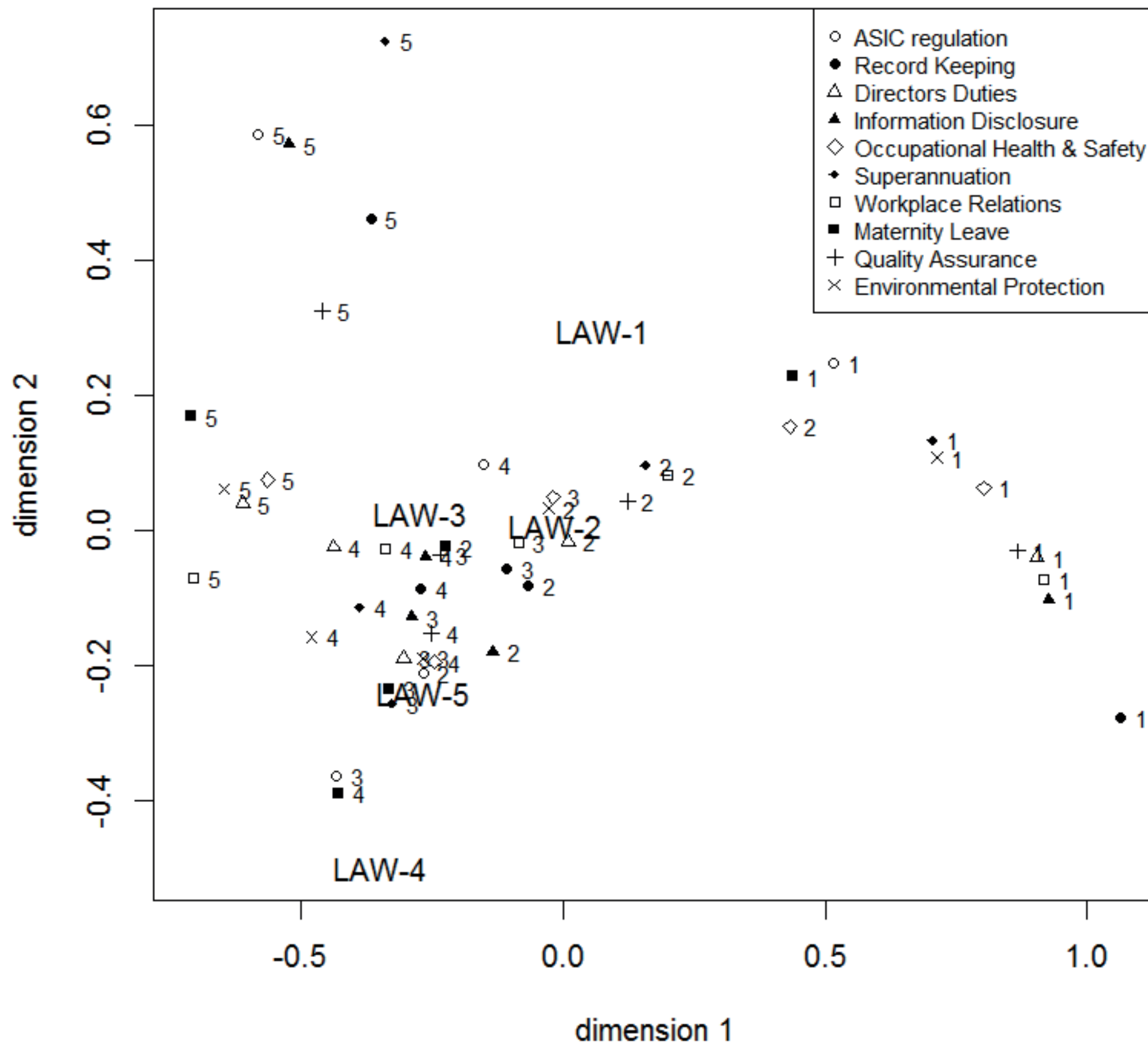


Figure 7 shows the association between the cost of compliance and expenditure on lawyer's advice.

It appears that there is a strong association between an increase in expenditure on advice from lawyers and an increase in the level of difficulty complying with various types of regulation. And the higher levels of expenditure on advice from lawyers may actually be caused by greater difficulty with compliance. Higher levels of expenditure on obtaining advice from lawyers do not appear to have any effect on easing the difficulty with compliance. Again, as with industry advice, there is a very clear threshold in the level of compliance difficulty before advice from lawyers is sought.

Figure 8 Compliance Difficulty by Accountant's Advice

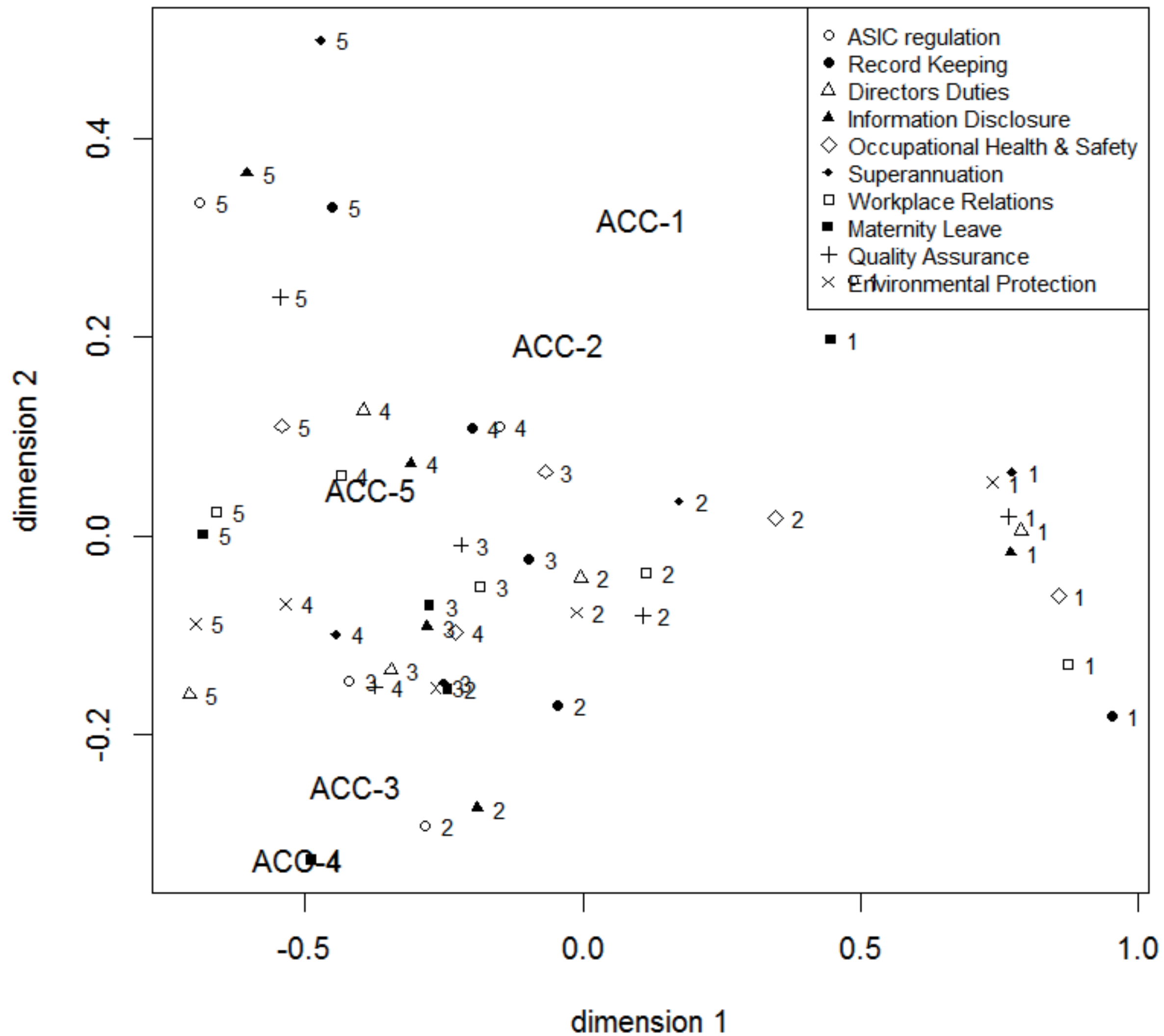


Figure 8 shows the association between the cost of compliance and expenditure on advice from accountants. It appears that there is an association between an increase in the level of difficulty with various types of regulation and an increase with expenditure on advice from accountants. However, at the higher level of expenditure, 20-24 percent and greater than 25 percent, is inversely associated with the level of compliance difficulty. This is perhaps evidence that at higher levels of expenditure, advice from accountants can have a considerable impact easing the difficulty of compliance. It appears accountants are the most useful source of advice for easing the difficulty with compliance compared with any of the other sources of advice considered. There is also evidence, similar to that for the previous sources of advice, i.e. industry and lawyers, of a threshold level of compliance difficulty below which advice from accountants is not sought.

Figure 9 Compliance Difficulty by Government Advice

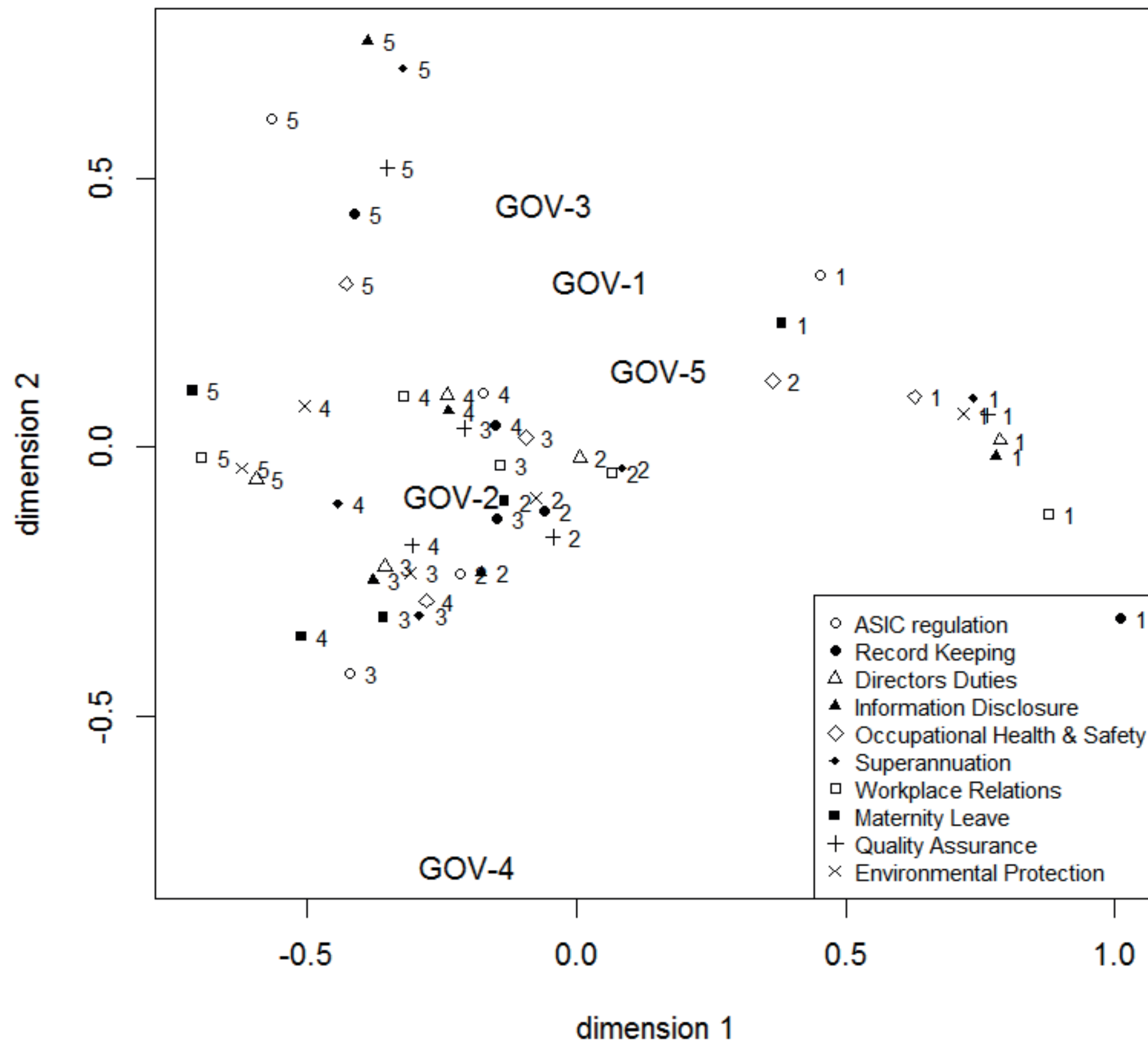


Figure 9 shows the association between the level of compliance difficulty and expenditure on government advice. Unlike any of the previous forms of advice, here, no clear association between the level of compliance difficulty and expenditure on government advice is observed. On the other hand, respondents are quite happy to make comments about the advice they get from government, some of it not complimentary. One respondent regretted

"the lack of support from government agencies e.g. the ATO - in assisting inexperienced business people to comply with their specific piece/s of legislation".

Another commented on a different level of government, lamenting

"the lack of commercial business sense experienced, particularly at local government or field officer status".

In summary, advice from accountants and industry did shows signs of reducing the difficulty associated with various types of government regulation. For most sources of advice, excluding government, a positive correlation exists between increasing the difficulty with compliance and expenditure on external advice. Moreover, it was also common to see evidence of a threshold level of difficulty before external advice was sought. This implies reducing the level of difficulty complying with various types of government regulation will save businesses considerable expenditure on external advice.

Conclusion

Clearly, businesses perceive that there are areas of compliance that cause differing levels of difficulty. In an earlier paper the authors (Lewis et al. 2014) found considerable concern among businesses regarding the amount of paperwork involved in keeping compliant and the complexity of the regulations exacerbated by various states and jurisdictions with different rules. These factors, in turn, create other problems, such as the difficulty keeping compliant with government regulation including getting staff to comply with government regulation, maintaining deadlines and understanding the requirements of government regulation. This is not helped by poor quality or overabundance of information which needed to be sifted through to find relevant information. These factors lead to a common charge from business that government over regulates the business sector making compliance costs greater than they need be. Furthermore, there is a common theme regarding additional regulation needed to fulfil the function of government, such as collecting taxes and superannuation payments, without any remuneration for the additional drain on the firm's resources to provide such functions.

This paper has extended the analysis of business perceptions using correspondence analysis to further investigate the links between the characteristics of businesses such as firm size, difficulty with various types of regulation and external advice.

The main findings of this paper are that although there is a positive relationship between firm size and difficulty complying with government regulation, the level of difficulty seems to have a minimum level even for the very small firms. Furthermore it appears that certain types of external advice, particularly advice from accountants, may operate to significantly reduce the difficulty firms have maintaining compliance. Although the use of professional advice can reduce the degree of difficulty of firms in complying with government regulation such advice is still a cost to firms which may unnecessarily detract from firms behaving efficiently and profitably.

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SMEs and Entrepreneurial Finance in OECD Countries: Good Practice and Lessons Learned

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Abstract

This paper will review the small and medium-sized enterprises (SMEs) and entrepreneurship finance policies and practice in OECD countries by gleaning the best evidence available. The paper treated SME financing as a governance issue and applied the governance analytical techniques. The study integrated both the supply and demand sides of the SME finance in the analysis of SME access to finance, credit reporting, alternative financing options, financing innovation and the situation of market failure. The review finds that Australia has fallen far behind the other OECD countries in making efforts to understand the demands of small business financing and hence failed to respond to such unmet needs due to lack of solid evidence. Good practice and lessons learned summarised from the review may shed light on the policy development for SME and entrepreneurship finance in Australia in the future.

Key words:
Small business financing, access to financing, good practice, lessons learned

> *"**Debt and equity are treated** not mainly as alternative financial instruments, but rather **as alternative governance structures**. Debt governance works mainly out of rules, while equity governance allows much greater discretion. ... A combined treatment of corporate finance and corporate governance is ... proposed. "*
>
> --- Williamson (1988, p.567)

Introduction

SMEs are an integral part of the modern economy. This section first defined the key terms of Small and Medium-sized Enterprises (SMEs) and SME financing. Then the SME financing issue has been identified as a governance issue, hence analytical frameworks on governance can be applied to the analysis.

Small and medium-sized enterprises: a definition

There are hundreds of definitions about Small and Medium-sized Enterprises (SMEs) globally (Ayyagari et al. 2007). For the purpose of the study, here the OECD definition is used. The OECD (2014) defines SME as a firm which employs less than 199 employees, excluding those in the financial service industry and excluding non-employing businesses. The above-mentioned OECD definition has been used consistently for data collection in OECD Countries, including Australia, as of 2011. However, Australia did not participate in previous data collections.

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SME financing: a definition

OECD (2013) defines SME financing as such activities that SMEs use to obtain and secure sources of funds for the purpose of business operation and expansion.

SMEs face numerous barriers to access finance, some of which include the following:

- Resource constraints
- Lack of collateral
- Lack of financial expertise
- Lack of knowledge about the financial market
- Limited products available for SME and entrepreneurial financing

SME financing: a governance issue

This study proposes the SME financing is a governance issue. The academic discussions around SME financing date back to the milestone which erected Corporate Governance as a discipline, the Jensen and Meckling's paper (1976, p.305). Their paper centres on the discussion of business financing and

> *"... investigate the nature of the agency costs generated by the existence of* ***debt and outside equity****, ... analysis of the factors influencing the creation and issuance of debt and equity claims is a special case of the* ***supply side of the completeness of markets*** *problem. "*

The view of business financing as a governance mechanism has been reinforced by Williamson (1988, p.567). He argues that

> *"****Debt and equity are treated*** *not mainly as alternative financial instruments, but rather* ***as alternative governance structures****. Debt governance works mainly out of rules, while equity governance allows much greater discretion. ... A combined treatment of corporate finance and corporate governance is ... proposed. "*

Given that the SME financing is a governance issue, the techniques of governance analysis can be used for SME financing. Such analyses include exploring market mechanisms and the government intervention, which will be discussed in the analytical framework below.

Analytical Framework

Putting OECD countries in the centre of the study and treating SME financing as a governance mechanism, the analysis starts with the assumption that the market functions well and the SMEs have access to the market and then moves onto the scenario when the market fails. The analysis unveils the real problem in SME financing or lack thereof.

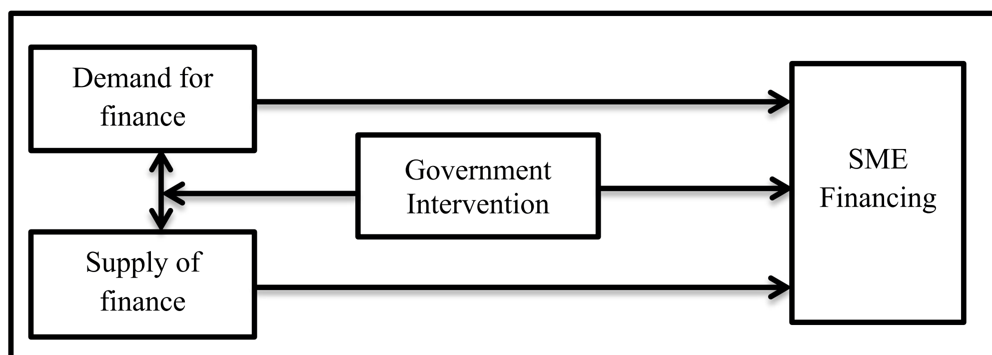

Figure 1 Analytical framework for SME financing

The analytical framework for SME financing is provided in Figure 1. From the market economy perspective, the demand and supply of finance determines the SME financing. However, due to information asymmetry between the lenders and the borrowers, the moral hazard during the borrowing process and that the market is imperfect, government intervention should be a necessary component of the governance system for small business financing (Fig. 1).

SME financing: A market economy analysis

Small business financing can be analysed using supply- and demand-side components, that include incentives, costs of financing, risks and information (World Bank 1999). The SMEs are the borrowers, while the financial institutions are the lenders (Table 1).

For lenders, the incentives for SME financing are mainly the interest rate on loans and to expand their client bases. Borrows would normally use additional financing as the means to expand their sales capacity which is largely determined by market demand and competition.

Table 1 Typology of market economy mechanisms

Factor	Lender - Supply	Borrower - Demand
1. Incentives	Interest rate on loan; building client base	Opportunity to expand sales capacity which is determined by market demand and competition
2. Costs	Time spent screening, monitoring, and ensuring repayment of loans	interest rate; time spent in applying for credit
3. Risks	Arrears or default if borrower is unable or unwilling to repay	Inability to repay loan may lead to bankruptcy
4. Information	Inadequate knowledge of customer's reputation and business prospects	Inadequate knowledge about dealing with banks or availability of credit
	Difficulty of appraising small loans	lack of adequate financial accounts on the firm
		uncertain about ability to increase sales enough to repay loan

The main cost for lenders are transaction costs, monitoring costs and enforcement costs which include the time spent on screening applications, monitoring of the SME loans and ensuring repayment of loans. The costs for SMEs are mainly interest and the time spent on preparing the loan applications.

Lenders may face the risks of arrears or default if borrower is unable or unwilling to repay given that they have inadequate knowledge of customer's reputation and business prospects. The SMEs which are unable to repay the loans may face bankruptcy. Moreover, the SMEs may have little knowledge about dealing with banks and the availability of credits.

The complexity facing lenders are mainly the difficulty of appraising SME loans. While for SMEs, the lack of collateral and tracked record of financial history and uncertainty about their market conditions creates challenges for their capacity to repay the loans.

The OECD (2014) report finds that the gap between the supply and demand of SME financing is widening year by year (Fig. 2). The widening gap between the supply and demand of SME finance is the actual problem, which cannot be adjusted by market mechanism. Hence government intervention is required.

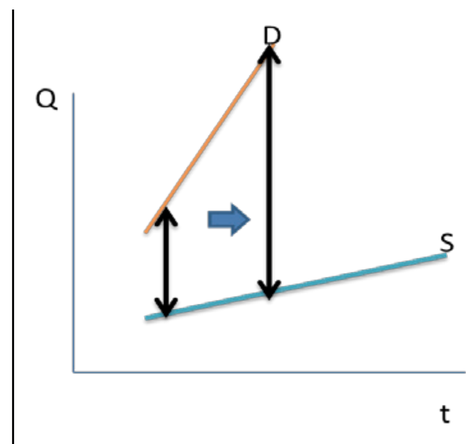

Figure 2 The widening SME financing gaps

SME Financing: Market Failure

The market failure for SME financing is mainly due to a few factors, such as SMEs' lack of collateral and lack of credit history, high screening and monitoring cost for SME loans, the oligopolistic lender market structure, and the technological innovations in banking and finance. Unless the financial and capital markets are competitive enough to address the SMEs' financing needs, provided that the transaction and monitoring costs can be substantially reduced, governments and SMEs should seek alternative financing options as a complement to the traditional banking instruments. Other OECD countries have made some effort to provide alternative mechanisms, while Australia is falling behind in such SME financing innovations. Below summarises some good practices and lessons learned from the other OECD countries.

Good Practices of the Other OECD Countries

There are six major alternatives to bank loans as financing options to SMEs, namely Mezzanine finance, Credit (SME loan) Guarantee, Peer-to-Peer Lending, particularly Equity-based Crowd-funding, Project Funding, Government Direct Assistance/Grants, Preferable Tax Treatments (Cumming 2012).

The Mezzanine finance is a combination of several debt and equity instruments in a single investment vehicle. In case of bankruptcy, mezzanine investors have higher priority than equity investors but lower priority than other creditors. Practically, Mezzanine finance requires SMEs to pay interest promptly and pay additional payments in the future which are contingent on the financial performance of the firm (OECD 2014). The Mezzanine finance is mainly a private ordering approach which balances the incentives, costs, information and risks as shown in Table 1.

The Credit Guarantee is a direct government or semi-government support to the SMEs to compensate for their lack of collateral and lack of track record of credit history.

Peer-to-Peer lending is an emerging technique which matches the financing needs from the SMEs at large and the supply of finance from the general public. A particular form which has attracted much attention for most of the governments around the world is equity-based crowdfunding. However, the development is still at its early stage. Though America passed the JOBS ACT in 2013 to facilitate crowdfunding, the take up is relatively low.

Project funding takes a different approach, rather than focusing on the SMEs, the funding decisions are normally centred on the projects. This approach is particularly useful for certain industries such as manufacturing and real estate, in which the projects are often long term and due to the nature of the

risks it is not that attractive to investors. Project funding mainly addresses the risk and information issues.

Table 2 Government policies of SME financing in OECD Countries

Policy response	Countries
Government loan guarantees	Austria, Belgium, Canada, Chile, Colombia, Czech Republic Denmark, Finland, France, Greece, Hungary, Ireland, Israel, Italy, Korea, Mexico, the Netherlands, Norway, Portugal, Russian Federation, Serbia, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Thailand, Turkey, United Kingdom, United States
Special guarantees and loans for start ups	Austria, Canada, Denmark, Mexico, the Netherlands, Serbia, United Kingdom
Government export guarantees, trade credit	Austria, Belgium, Canada, Colombia, Czech Republic, Denmark, Finland, Hungary, Korea, the Netherlands, New Zealand, Spain, Sweden
Direct lending to SMEs	Austria, Belgium, Canada, Chile, Colombia, Czech Republic, Finland, France, Greece, Hungary, Ireland, Israel, Korea, Norway, Portugal, Serbia, Slovak Republic, Slovenia, Spain, Sweden, Turkey, United Kingdom
Subsidized interest rates	Austria, Greece, Hungary, Portugal, Russian Federation, Spain, Turkey, United Kingdom
Venture capital, equity funding, business angel support	Austria, Belgium, Canada, Chile, Denmark, Finland, France, Greece, Hungary, Ireland, Israel, Mexico, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Turkey, United Kingdom
SME banks	Czech Republic, France, Portugal, Russian Federation, United Kingdom
Business advice, consultancy	Austria, Colombia, Denmark, Finland, the Netherlands, New Zealand, Sweden
Tax exemptions, deferments	Belgium, Finland, Italy, New Zealand, Norway, Spain, Sweden, Turkey
Credit mediation/ review/code of conduct	Belgium, France, Ireland, New Zealand, Spain
Bank targets for SME lending, negative interest rates for deposits at central bank	Ireland, Denmark
Central Bank funding to banks dependent on net lending rate	United Kingdom

Source: OECD (2014) p. 41.

Government Direct Assistance/Grants include policies such as government loan guarantees, government export guarantees, trade credit, direct lending to SMEs, government procurement (Table 2).
Preferable Tax Treatments are tax benefits targeting at particular industry or business groups, such as exporting SMEs and start-ups (Table 2).

Lessons Learned from the Other OECD Countries

The review also draws some lessons from the policy reforms in SME financing, in OECD countries related to the poor competition of SME banking lack of data and the quality of data, as well as consistent definitions of SMEs.

SME financing or lack thereof in OECD countries has suffered from lack of competition for SME lending. Denmark's central bank has introduced negative interest rates for bank deposits at the central bank to encourage commercial lending in the real economy (OECD 2014).

Though the OECD made the joint efforts to collect data on the supply and demand of SME finance, lack of data is still a major issue given that a great number of SMEs are excluded from the formal financial system. Even for countries where data may be available, different government departments are reluctant to share their data.
The quality of data and definition of SMEs are technical issues challenging the SME financing reforms. In particular, at this stage, all the OECD data excludes non-employing SMEs from the data collection. It is widely acknowledged that such omission is a significant one and will have tremendous impacts on the design and evaluation of policy options.

Implications and Future Work

The review of the SME financing policies in the OECD countries found that

- The SMEs are disadvantaged in accessing finance. Government should intervene.
- There is no quick fix for the SMEs financing problem.
- There is always more than one option available from good practice of the other OECD countries.
- Australia has to take prudential steps to catch up with the other OECD countries in providing more and easier loans to SMEs.

Hence, future research should endeavor to establish the evidence base for various options of SME financing. In addition, Australia should join the other OECD Countries in SME finance related data collection and analysis. Future work should also attempt to resolve the data quality and SME definition issues.

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Governance in Family Business: A Literature Review

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Abstract

Public and academic discussion on corporate governance and its related issues are clearly visible in any country with active capital markets. This suggests that good governance is a crucial factor for ensuring economic development. However, few studies can be found relating to non-listed or smaller firms. With the aim of contributing to this knowledge gap, this study reviewed the literature specific to corporate governance in family business in an emerging market, Sri Lanka, a small developing country with average lower middle income. The development of corporate governance best practices in Sri Lanka has been strongly affected by British models and systems, which derive from the Anglo- Saxon model of corporate governance. However, previous researchers who found that ownership of many listed companies was concentrated mainly in individual shareholders or a family concluded that family business in Sri Lanka is very critical to the economic development of the country. This study presents a review of non-listed and small to medium family business, and their two-tier mechanism of governing.

Key Words
Corporate Governance, Family Business, Family Involvement

Introduction

Good governance is a crucial factor for ensuring economic development. Historically, different corporate governance systems have developed around the world due to specific political, social, economic, cultural and religious norms (Licht, Goldschmidt, & Schwartz, 2005). Therefore, in the new global world, a convergence in corporate governance is taking place more rapidly than before. Even though corporate governance practices and codes stepped up from developed economies and spread into all over the world, these models may not be one hundred percent suitable to emerging markets such as Sri Lanka.

Though there is a vacuum in the academic literature on corporate governance practices in emerging markets, a number of studies on corporate governance can be found not only in Sri Lanka but in every corner of the world. Most of this attention has focused on large listed corporations (Gabrielsson & Huse, 2004; Hart, 1995) and little empirical work relates to smaller business (Wellalage & Locke, 2011) and family business. Further knowledge of corporate governance on Sri Lankan family business suffers from a deficiency of research studies. This study helps to fill this gap by adding new insight into the existing literature on corporate governance in family business in Sri Lanka.

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Corporate Governance

Corporate governance is a pivotal subject in business literature (Colarossi, Giorgino, Steri, & Viviani, 2008). It concerns the exercise of power to direct and control companies (Clarke, 2004). As explained by Manawaduge (2012), corporate governance facilitates achieving company objectives, explicates the ways and means of making business decisions, stipulates the distribution of rights and responsibilities of the management and

other stakeholders, and aligns the company behaviour with the expectation of the society . Hence, corporate governance has significant implications for the financial stability and performance of companies and thereby the economic growth of the country (Rezaee, 2009). Even though corporate governance as a concept has been acknowledged for decades, due to the Asian financial crisis in 1997 and more recently the accounting scandals in Europe and the United States, it has earned much attention worldwide. There is no universally agreed definition for what the term corporate governance means, although numerous definitions have been discussed (Anandarajah, 2004). However, defining corporate governance is a difficult exercise because of different culture, legal systems and history (Ramon, 2001). Put simply, as in Heenetigala and Armstrong (2011) and Adams et al. (2011) corporate governance is concerned with internal structures and processes for decision making, accountability, control and behaviour at the top of organization (Clarke, 2004), and mechanisms for accountability (Armstrong, Li, Heenatigala, & Clarke, 2011) to the stakeholders.

Two main schools of thought laid the foundation for corporate governance theory, Agency theory and Stakeholder theory. The traditional agency relationship explains that an agent acts on behalf of another (the principal). Many agency problems arise when the goals of the principal and agent are different and conflicting (this is known as the principal–agent problem or the agency dilemma) and when it is difficult or expensive for the principal to verify what the agent is actually doing (Herrero, 2011). Further in small and family business the owner/ shareholder acts as both the principle and agent. On the other hand, all the individuals and groups who can affect or affected by the activities of a firm can be regarded as stakeholders. Stakeholder theory clarifies that managers should make decisions that take account of the interests of all the stakeholders in a firm (Jensen, 2001). These two theories consider the way that owners can structure the corporate governance systems of their business from different perspectives (Colarossi et al., 2008). However, corporate governance has wider implications, for the economic development and social well-being of a country, by way of providing incentives to achieve business performance, and accountability and transparency and to ensure an equitable distribution of wealth (Clarke, 2004).

Thus, good governance is a key factor for stable economic development. Corporate governance in developed markets has evolved gradually over centuries as a result of the economic development of industrial capitalism (Chowdary, 2003). However, compared to developed countries, corporate governance has not received as much attention in the context of developing countries (Klautzer, 2013). Further, because of economic, social, and cultural differences between developed and developing countries, the practice of corporate governance in developed countries may not the perfectly suitable for developing countries. Being a developing country, this situation is the same for Sri Lanka too.

Corporate Governance in Sri Lanka

Corporate governance of a country may depend on particular country's own contextual factors such as the political, cultural and historical characteristics of that country. Sri Lanka is a small, market oriented, developing country with average lower middle income levels. The origin of corporate governance goes back prior to colonization, when Sri Lanka was a centralized kingship state (Heenetigala, 2011). The king was the ultimate owner of the land governing the entire country with an authoritarianism, hierarchically defined cast system (enshrined in a distinct occupation system from highest to lowest) (Heenetigala, 2011), and rituals. No governance of separate enterprises seemed necessary since economic activities were organized within the framework of the cast system.

After the kingship regime, Sri Lanka was subjected to centuries of Portuguese, Dutch and British domination (Wellalage, 2012). In the British era companies were governed by English Law. During this time, with the establishment of plantation companies, funds and expertise were channelled from Britain. Share trading was introduced through British investors' contribution of capital through the London stock market and the Colombo Brokers Association (Manawaduge, 2012).

The next key point was the introduction of open system policies in 1977. With the shift from a socialist to a market oriented economy, many foreign investments flowed into the country and this led to the introduction of formal legislation to regulate companies. In 1982, the Companies Act and later the other corporate governance laws were passed regarding the functioning of the joint-stock companies and protection of investors' rights (Wellalage, 2012).The Security and Exchange Commission (SEC) was established in 1987 with the responsibility of developing rules and regulations for financial reporting and the capital market in Sri Lanka. The first Sri Lankan corporate governance code was introduced in 1997 by the Institute of Chartered Accountants of Sri Lanka (ICASL) to deal with financial aspects of corporate governance of Sri Lankan listed companies (Senaratne & Gunaratne, 2008). This was adapted from the Cadbury Code (1992) - Financial Aspects of Corporate Governance, the first code of corporate governance introduced in UK and the first code of best practice developed based on the Anglo-Saxon model of corporate governance. Corporate governance standards were mandatory for all listed companies for the financial year starting on or after 1st April 2008. These mandatory rules were developed through a joint initiative of ICASL and SEC in consultation with the Colombo Stock Exchange (CSE) (Senaratne & Gunaratne, 2007). Thus it is clear that the development of corporate governance best practices for Sri Lankan companies have gradually proceeded over a period of time from the introduction of the first code of best practice in 1997 to the introduction of minimum rules of corporate governance for mandatory compliance of listed companies in 2008.

Therefore, it is evident that the development of corporate governance best practices in Sri Lanka has been heavily influenced by British models and systems, derived from the Anglo-Saxon (market based) model of corporate governance. Hence, the notable feature of corporate governance reforms in Sri Lanka is the close allegiance with the Anglo-Saxon model of corporate governance (Senaratne & Gunaratne, 2008). However, from an ownership perspective and a banking relationship perspective, Sri Lanka's corporate governance system is very different from the Anglo- American system (Wellalage, 2012). This argument can be supported the findings of Senaratne and Gunaratne (2007) that the concentrated ownership structure of many Sri Lankan listed companies, with a controlling shareholder and a family or a group of closely related individuals as the ultimate owner, strongly influences the governance structure and practices especially the appointment and independence of directors.

This high degree of ownership concentration, acts as a hindrance to an active takeover market and a liquid stock market. Plus a low number of arms-length institutional shareholders is very frequent in Sri Lankan companies. This situation is closely associated with the variation in the socioeconomic and political conditions of Sri Lanka that are unlike those of Anglo-American countries. Compared to these countries, Sri Lanka is a collectivistic society, which promotes family ownership. The investments of the general public in the CSE are low, which in turn to a certain extent is associated with elitism (i.e. dominance of an elite group of businessmen or families) and an emerging business class with political power and patronage in the Sri Lankan society. (Senaratne, 2011). Further according to Edirisuriya (2007), Sri Lanka's corporate structure is dominated by banks in the financial sector. Banks are the primary financial supporters of companies and the two often have complex and long relationships. Due to a weak legal structure and undeveloped microeconomic environment, Sri Lankan companies are highly dependent on banks for capital funding and Sri Lanka's corporate debt level is significantly less than developed countries (Wellalage, 2012). According to the "Investment Climate Report" (2009), state sector banks are dominant in the banking sector and comprise 40% of total banking sector assets. These characteristics of ownership - the bank-company relationship, debt, and government interventions - work to create a structure in the micro economic environment. In which state interference is comparatively higher in Sri Lanka than in other Anglo-American model countries. Therefore, the Sri Lankan model of corporate governance mechanisms is distinguished from the Anglo- American model and creates a unique corporate governance environment.

McKnight and Weir (2009) and Ward and Filatotchev (2010) reported that the efficiency of corporate governance mechanisms associated with publicly listed companies is the subject of extensive ongoing research in the literature. The same situation could be seen in literature belonging to Sri Lankan

corporate governance. It is evident that much less is reported on governance of small firms. As a reason for that, in 2011, Wellalage and Locke pointed out that the limited data available for research on corporate governance in smaller firms undoubtedly has contributed to the limited literature concerning governance in smaller firms. More interestingly even less was reported on family firms regardless of the size of family firms. Therefore, this paper is an effort to contribute the existing knowledge base by adding literature on family firms' governance.

Corporate governance in family firms in general

Throughout the evolutionary process of family business, various and numerous definitions of family business could be seen, but still there is no one common definition. Among the numerous definitions of family business, which are gathered around the ownership in the book of "Family Business in Tourism and Hospitality" by Getz, Carlsen, and Morrison (2004), family business is defined as any business venture owned and or operated by an individual, couple(s) or a family. Further Chua, Chrisman, and Sharma (1999) defined family business as firms that are owned and managed by family members and seek to ensure trans-generational involvement through the family (Chua, Chrisman, & Chang, 2004). Olson et al. (2003) defined family business as a business that was owned and managed by one or more members of a household of two or more people related by blood, marriage or adoption. Hence, many companies are founded as family businesses (Brenes, Madrigal, & Requena, 2011). Accordingly, it is an important fact that empirical research highlights the predominance of family-owned firms around the world, particularly in emerging markets, including business with the least restrictive definitions of family involvement in a firm (Sharma & Nordqvist, 2008). Therefore, a family business can be defined as a company mostly owned and managed by a single root family. In family owned or controlled businesses, families hold and control a major part of the economy and therefore they design the governance structures that benefit them. Further Neubauer and Lank (1998) revealed that the key elements of a typical corporate governance structure for a family business are the family and its institutions, the board of directors and top management. Hence, family firms rely on the concentration of ownership to achieve the same objectives set out by mandated corporate governance practices.

The complex interaction between the family and the firm creates several difficult governance issues (Wellalage & Locke, 2011). For instance, the ownership and control, succession, performance, and governance structures are frequently discussed. This is a common situation in any economy. Mallin (2004) who claims that, when a family business is at stage when it is becoming more difficult to manage, it effectively impedes its efficient operation and development. Then is the time to develop more formal governance structures. Therefore it is clear that governance is highly related to family businesses and their growth.

Succession is a crucial factor, among the critical factors leading to problems within family businesses (Brenes, Madrigal, & Molina-Navarro, 2006). Family business continuity plans commonly establish a governance structure for the family and for the family business (Brenes et al., 2011). The purpose of those structures is to improve strategy and control mechanisms of the family business and, to organize the communication and relationship between family owners and business executives (Brenes et al., 2011). Beside the supervision and control of management, family businesses need to establish governance structures that enhance cohesion and shared visions within the family, while at the same time reducing harmful conflicts (Mustakallio, Autio, & Zahra, 2002). Correspondingly, the consideration of the family dimension (i.e. family governance) is an integral part of the governance structure of family firms (Klein, 2009 as in (Siebels & Knyphausen-Aufseß, 2012)).
From the performance perspective, research by Anderson and Reeb (2003) and Villalonga and Amit (2006) find that family firms outperform non-family firms. And Andersona, Mansib, and Reeb (2003) show that family firms incur lower debt cost relative to non-family firms as well. Moreover, based on the size of the family business, or whether the business is listed or not, governance structures of family business may have differences. Further the stage of development of a family enterprise impacts the governance structure (Neubauer & Lank, 1998).

Siebels and Knyphausen-Aufseß (2012) disclosed through the previous literature that following a systems approach, the internal governance of a family firm is defined as two interacting subsystems: the business and the family governance system. The business governance subsystem is defined as the organization of administration and control of the business and consists of the top-management team (TMT), board of directors and shareholders' meeting. The family governance subsystem is designed to secure and organize the cohesion within the family and consists of a family governance system (Gallo and Kenyon- Rouvinez 2005 as in (Siebels & Knyphausen-Aufseß, 2012)). The board of directors and the family council are core elements of the governance structure of a particular family business.

Though there is no universally accepted single theory or view that makes sense either in governance generally, nor in family firms in particular, a governance structure aids the achievement of goals of a family business through direction and supervision. As a consequence the governance discussion in the family business field has received much attention during the past years (Pieper, 2003). Moreover the focus of research on family business governance has evolved over time, from an almost exclusive focus on individual governance bodies and structures, mainly on the role of the board of directors in the family firm, to a different approach emphasizing the governance system as a whole (Pieper, 2003).

Corporate governance in family firms in an Asian Context

Hofstede (1994) revealed that Asian societies are collectivistic societies, which show concern for much wider group interests and emphasize belongingness that can extend to organizations. Consequently, Khan (2003) highlighted that the predominant form of large and medium scale enterprises in developing Asia are family-controlled or family-owned. Similar to Khan's statement, in Sri Lanka too, Senaratne and Gunaratne (2007) found that the ownership structure of Sri Lankan companies is largely characterized by family-controlled, pyramid, cross-holdings, with the controlling shareholder usually being another corporate entity. Based on the study done by Masulis, Pham, and Zein (2009), it was concluded that family business groups are more important in emerging markets. For example, they further revealed that the proportion of listed firms belonging to family business groups is at least 30 percent in Chile, Colombia, Israel, Philippines, Sri Lanka, and Turkey, with Sri Lanka being the largest at 64 percent. Further, Senaratne and Gunaratne (2007) found that the ultimate controlling shareholder in most Sri Lankan companies is an individual or a family as in most other Asian countries. More interestingly, according to KPMG web site Sri Lankan Family Businesses are playing a significant part in the impressive recovery of the domestic economy ("http://www.kpmg.com,")

Even though in this literature review, it was expected to discuss corporate governance of listed family business and non-listed family business in Sri Lanka, it was found that the research studies on corporate governance of non-listed family business are very limited.

Corporate governance of listed family Businesses in Sri Lanka

Mustakallio et al. (2002) found with their research that the corporate governance in family firms differs from that in non-family firms because owners have multiple roles in a family business. In the Sri Lankan context, where family-owned or controlled companies are the prominent type of business organization, this is the case not only in small and medium scale companies in Sri Lanka, but Masulis et al. (2009) found that 64% of listed companies too are family controlled. As explained by Shenoy (2014), Hemas Holding Group Director, Abbas Esufally revealed the main reasons that a family business tends to be publicly listed are incentives, compliance, attracting top people, and the need of funds. To elaborate this further, Manawaduge and Zoysa (2013) disclosed that most of the Sri Lankan firms have stable ownership structure and therefore ownership is more likely to be exogenous to performance. Furthermore, direct managerial ownership in Sri Lankan companies is relatively small, because ownership is usually dominated by another corporate entity. These entities usually have family ownership as the ultimate owners, and therefore, direct managerial ownership does not play an

influential role in the Sri Lankan context. And the existence of family ownership as a controlling shareholder, either through direct ownership or through another corporate entity, is a common feature of Sri Lankan listed companies. Hence, the key concern of family ownership is that it leads to the majority of directorships in these companies being held by the family members and the transferring of the management of the companies from one generation to another of the controlling shareholder family.

Supplementary to this , inadequacies in the Sri Lankan legal structure for the protection of investors' rights have also contributed towards the presence of a controlling shareholder (Senaratne, 2011) . Further the study done by (Wellalage & Locke, 2011) found that traditional corporate governance mechanisms cannot mitigate principal-principal agency conflict in family firms in emerging markets. More importantly, their study indicated a requirement for the promulgating or streamlining of corporate laws in emerging markets to reduce the possibility of expropriation of minority shareholders by politically-powered family firm owners.

Corporate governance of Non-listed large family Business in Sri Lanka

Due to the absence of empirical studies specific to the governance of non-listed family business, this section is primarily based on the valuable facts revealed by an article written by Shenoy (2014) in Daily Fit e-paper relating to the seminar on 'Family Owned Businesses' conducted by the Sri Lanka Institute of Directors at the Cinnamon Grand, Colombo (2014). The participating family business leaders in a panel discussion confirmed that that the engine of growth in the Sri Lankan economy has been the private sector, with family-run businesses from small to large scale.

Family Involvement in Governance

Family governance is distinguished not by the separation but by the unification of ownership and control (Carney, 2005). This makes family business different from widely-held corporations. At the same time this makes governance in family business more complicated due to not being able to apply a typical corporate structure because of the central role that the family plays in ownership and management (Faizal Salieh as in Shenoy, 2014). Therefore, family businesses are governed within unique governance structures which are unique to individual family businesses. Hence, a family dimension is an integral part of family business governance and also the cause of the difficulties in management. Further impact of family members who do not actively involve in family business is also very vital for the family business continuation. To explain this further the statements of active members of leading Sri Lankan family businesses which are not listed could be used:

> *"In our case, it's the role our mother plays, although she wasn't actively involved in the business. If we took decisions without telling our father, we'd get a call from mother telling us off. So in a way, it was a form of informal governance and balance in keeping the family together".*

> *"Our unwritten rule, with just six of us, is that whatever disagreements we have, we discuss it in the evening. As a family rule, we talk to each other every day. Not a day goes by without things being resolved at the end, and the next day it goes back to business as usual".*

> *"We too have structured family meetings once a week, discussing either business or personal aspects. No phones, no interruptions for one hour. A lot is achieved".*

Elaborating this further, to handle emotional issues which could not be handled with a corporate approach, the role of "Chief Emotional Officer" (Faizal Salieh as in Shenoy, 2014) should be played by an appropriate individual in a family business. This would help to overcome agency problems and reduce the negative aspects of altruism. Hence, it is evident that explicitly or implicitly a Sri Lankan

family business uses a family council to govern the business. This would be formal or informal as evident by the above.

Decision Making

Basically founders of family businesses tend to make decisions at their own risk and calculate their own rate of return. However, with the next generation's involvement, decision making becomes more formalized and decisions are made via risk committees and other formal bodies. By explaining this situation further major Sri Lankan family business leaders have agreed that though founders put more weight on their inner feelings and intuition, structured governance is truly important for the next generations. As the reason for this, one of the family business leaders, (Shenoy, 2014) expressed his view as

> *"A lot of things in the early day were based on gut and emotion. Public companies and families are two different things, and we're trying to find a happy medium. The gut feeling is exciting, but rational decisions must be made".*

More importantly another key point he made was that with the end of the war many businesses needed longer term investment policies and for that a more structured way of governance as indeed need. This does not suggest that the only important mechanism is formal rules and regulations to govern the business. However as family business members have the freedom to do so, their own way of making decisions could be used when it is needed. This is indicated by the statement stated in Shenoy (2014) as

> *"If all the rules and regulations worked, I wouldn't be here. It is gut feeling that brings people to their decisions. When I was about 29, I recall telling my dad not to buy something as I didn't feel we could afford it. Now of course, we have different advisors and committees. But at the end of the day the gut feeling needs to govern you sometimes. If you're bogged down by committees, the business cannot grow".*

Therefore it is clear that decision making processes in family businesses unlike in other corporate bodies is a two-phase process which involved both rational decision making process as well as family members' intuition.

The future of Sri Lankan Family Business

Family businesses tend to turn into public listed companies due to several reasons, such as capital for growth, attracting talent employees, seeking foreign investments, to lessen the agency problems. However, the strategy they would prefer to practice, is making their subsidiaries public and keeping hold the company as a family business. This was confirmed at the seminar on 'Family Owned Businesses' conducted by the Sri Lanka Institute of Directors at the Cinnamon Grand (2014). The participating family business leaders in a panel discussion agreed that, along with a rational justification to be public, it would be appropriate to be a listed company. On the other hand, the best option would be listing subsidiaries while keeping the holding company a family business. Further, they revealed their strategy of partnering with big publicly listed companies in terms of the betterment and continuation of the family business in future.

Corporate Governance of Small to Medium family business in Sri Lanka

Corporate governance of family business may have differences occurring with the changes in the size of the business. Even though corporate governance practices are not compulsory for non-listed family business, many large family businesses which are not registered in the Colombo Stock Exchange do follow formal corporate governance practices such as forming a Board of directors and relevant committees. However, this situation could be different in relation to small and medium size family

businesses since they do not follow many rules and regulations apart from a few that are compulsory such as registration of the name of the business and other tax related requirements. Further, studies done with small and medium enterprise (SME) in Sri Lanka revealed that many SMEs are sole or family owners. Findings of the study conducted by (Dissanayake & Kodithuwakku, 2011) revealed that there exists a positive relationship between the supportive family member contribution and the small family business success. Furthermore, most successful small family businesses received support from their family members via emotional, instrumental social (paid/unpaid work), instrumental material support (financial and/or other resource needs) and nominal forms. Nominal or dummy contributions of family members is a new form of family member support which emerged during the initial phase of their study, it is defined for the purpose of the study as the support the family members extend to the business through their fame, recognition and/or societal status without actively contributing to the business operations via any other identified forms of contributions. Dissanayake and Kodithuwakku (2011) concluded that the more a given business receives family member support through all forms of identified contributions the more the small family business success will be. Further in many SMEs in Sri Lanka the owner is the ultimate decision maker whose concern with the formal process of director boards, committees and meetings on managing and controlling the business are very rare (Weerakkody, 2009). However, still published studies relevant to this area are very less. Therefor there is a significant need to conduct empirical research on governance in small and medium family businesses in Sri Lanka.

Conclusion

The key concern of family ownership is that it leads to the majority of directorships in these companies being held by the family members and transferring the management of the companies from one generation to another of the controlling shareholder family. With the constraints of the lack of previous studies in governance in family business, this study followed some key facts revealed by leading Sri Lankan family business members at the seminar on ‘Family Owned Businesses’ conducted by the Sri Lanka Institute of Directors at the Cinnamon Grand, Colombo, Sri Lanka in 2014. The participating family business leaders in panel discussion disclosed that the family plays a critical role in governance with family discussions and meetings. More formally, this could be called family meetings or councils. Further they confirmed that unlike in other corporations, governance in family business is a two-tier mechanism involving both unstructured and structured components in governance process and decision making. Specially, though, managing a business with one’s own intuitive style sits well with founders. Written down formal governance process is required with the involvement of second and third generations. More importantly converting the business into listed public company is dependent on the needs of the business and this is not essential for growth. Further a Sri Lankan family business, with the right balance of business and family, could perform best with the involvement of several generations. This was evident in the Hirdaramani Group, one of leading apparel family business in Sri Lanka, which is governed by the fourth generation (Shenoy, 2014). Hence, as an emerging economy Sri Lanka has benefitted by family business. On the other hand governance in Sri Lankan family business as a field of research suffers from a lack of literature and empirical studies. Very few empirical studies on listed family business governance and no any empirical study on non-listed family business governance could be seen. Therefore these areas can be researched further based on different factors. For instance, a study could find out whether there are differences in non-listed family business governance based on size as small, medium, and large. Moreover, no study could be found on differences between listed and non-listed family business governance. Hence, this would be a great opportunity for researchers to explore and find fruitful facts relating to family business governance in an emerging economy.

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The Corporate State: Historical Prospective on International Industrial Relations

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Abstract

Since the 1970s transnational corporations have increasingly sought to move business to locations where labour was cheapest. They saw this as an opportunity to maximize profit and reduce tax. The paper compares the experiences of Singapore and Hong Kong, the first wave of countries to open their markets to foreign corporations, with other countries such as Bangladesh and Myanmar which are the latest countries to enter into the 'cheap labour for hire' business. The paper argues that countries that do not have strong government policies face having their country being used for forced labour by unscrupulous corporations and individuals seeking to make huge profits.

Introduction

The creation of the United Nations ('U.N') and International Labour Organization ('ILO") led to the recognition of Universal Human Rights and greater acknowledgement of workers' rights[1]. The United Nations was instrumental in fostering greater economic ties with all signatories' members through conventions and treaties. Many of these conventions and treaties focused on the fostering closer economic ties by creating a uniform legal system such as the UNIDROT model law in contract law so companies could do business in other countries easier[2]. Meanwhile, the ILO to this day has sought to represent the rights of Worker's Rights and ensure that Workers' are treated fairly and humanly. However, in the 1970's the ILO was in conflict with the United States Government over its fights for social justice which resulted in funding for the ILO being cut. It was only reinstated when the ILO promised it would no longer use a Human Rights approach to Worker's Rights and instead it would follow the 'Washington Consensus'[3] . This shift had led to the ILO avoid linking human Rights to Workers Rights even to this day[4].

The paper will examine how institutions such as the United Nation and International Labour organizations expanded the concept of universal human rights for all. Yet, increasingly economics and profit maximization by transnational corporation is limiting the scope and applicability of these fundamental Human rights. The paper will focus on the issue of 'forced labor' of workers which is now estimated to be at 21 million worldwide. It will explore how corporations have played the first world against the third world all in the quest for profits maximization. The paper will conclude invariably it is the poor that end up paying the price and unless human rights principles are expanded to all, forced labor will only increase in the future.

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[1] Herbert Kronke, The UN Sales Convention, The UNIDROIT Contract Principles and the Way Beyond, 452 Journal of Law and Commerce, Vol 2, 451

[2] Ibid Beigbeder, Yves (1979). "The United States' Withdrawal from the International Labor Organization". *Relations industrielles / Industrial Relations* **34** (2): 223–240. doi:10.7202/028959ar.p 451

[3] Standing, Guy (2008). "The ILO: An Agency for Globalization?". *Development and Change* **39** (3): 355–384. doi:10.1111/j.1467-7660.2008.00484 x. Retrieved 4 August 2012.

[4] Ibid p 355.

Historical prospective of economic development of first world nations

After the 1945 the United Nations was created to replace the League of Nations. The purpose of the United Nations was to enshrine universal human rights for all. This was done to avoid the horrors of the second war and the persecution of the Jews and other minorities who were not protected by any laws of a particular nation[5]. In order for a nation to join the United Nation they had to become signatories to the various conventions and treaties which seek to make universal human rights the basis for every citizen of the World. However, the United Nations is an umbrella organization with other sections such as the International Labour Organization, The World Food and The World Health Organization. They have also been instrumental creating treaties and conventions for countries and corporations to business with each other. Such as the UNIDROT model which attempted to make contractual relations easier for business wanting to engage in international trade and commerce[6]. The U.N has been an effective player in protection human rights and helping globalize the world's economy.

However, in order to achieve many of these gains the U.N and ILO has had to exercise great restraint or risk the possibility of alienating certain members. Currently, there are five committee members who are permanent members; these include U.S.A, China, Russia, Britain and France[7]. They provide the bulk of the funding to the U.N activities and as a result exercise and great deal of power because they can veto bills or remove funding all together. In 1975 the ILO allowed a U.S.S.R member to join its board and in addition it sought to make a resolution regarding the plight of Palestinian people. The U.S.A walked out the meeting and send notice revoking their membership to the organization for 1977 time period and they are stated that they would cancel all funding for ILO which was 35 percent of all funding to ILO[8]. This would have had detrimental effect on the organization from this point onward the ILO moved away from viewing workers' rights through human rights. Instead they were forced to adopt the 'Washington Consensus' which advocates free trade and the expansion of market forces in the domestic economy[9]. The threat to revoke membership and funding has forced the ILO to avoid the thorny issue of human rights and forced labor in the same sentence. Unfortunately, to do otherwise would mean there would be no governing international agency focusing on workers' rights but such restriction on the ILO allowed certain groups and nations to exploit it agreement for their own means.

Corporations Playing the 3rd World Against 1st World

After the Second World War most countries including as Canada, the U.S.A and Australia experienced a massive economic expansion[10]. In Australia the government had already had introduced wage centralization but they adopted Keynesian economic which advocated the use of trade barrier to protect domestic industries. Australia had a strong union movement and fought successfully to maintain workers' rights and conditions[11]. From 1945 to 1970 the pay and working conditions of Australian increased substantially. Keynesian economics was credited for creating 'Golden Age' for capitalism. However, as a result of the petrol crisis, the gold standard crisis and the emergence of stagflation Keynesian economics was removed in favor of Milton Freedman's theories that governments are over regulated and which believed that the role of governments should avoid involving itself in wage centralization and trade barriers should be removed altogether[12].

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5 Hoopes, Townsend; Brinkley, Douglas (11 July 2000). *FDR and the Creation of the U.N.* pp. 1–55.. Retrieved 2014-11-13.
6 Osmańczyk, Edmund Jan (February 2004). *Encyclopedia of the United Nations and International Agreements: T to Z.* Taylor & Francis. p. 2445.
7 Op cit n 4 at 231
8 Op cit n 5 at 351
9 Op cit n 5 at 351
10 Robert Skidelsky (2009). *Keynes: The return of the Master*. Allen Lane. pp. 116, 126.
11 Brian McKinley, (1979). *A Documentary History of the Australian Labor Movement 1850-1975*) pp: 121-125
12 Ibid p 126

The Emergence of the 3rd World

However, by the late 1960's and 1970's the world witnessed unprecedented economic growth and the emergence of transnational corporations[13]. As the other economics began recover from the destruction of infrastructure during the Second World War, they also began to economically improve their financial situation. Many transnational corporations saw great opportunity to expand their market share in these countries which had not been viewed in the past as being viable. In addition, such countries presented an opportunity to move their business operations as they were cheaper in taxes and wages[14]. Moreover, these countries had laws which restricted trade union militancy. Therefore, unions had a very limited role to play in industrial relations. Transnational corporations saw this as an opportunity to maximize profit and reduce tax[15]. The paper will use as a case study Singapore and Hong Kong. As they were the first wave of countries to open their markets to foreign corporations and compared this to other countries such as Bangladesh and Myanmar which are the latest countries to enter into the cheap labour for hire business. The paper will argue that countries that do not have do not have a strong government policies face having their country being used for forced labour by unscrupulous corporation and individuals seeking to make huge profits off the back of workers.

First Wave of Industrialization

In 1961 Singapore joined with Malaysia and formed a union together. By 1965 the economic union between Malaysia and Singapore collapsed. Singapore was officially kicked out of the union and forced to fend for themselves[16]. Singapore was a very small nation state and it was believed that they would not survive without the help of another country. Additionally, Prime Minister Lee Kuan Yew sought to make Singapore a place to do business for transnational corporations to help him turn Singapore into an economic powerhouse[17].

However, to get their support the Yew Government removed the opposition party which was closely aligned with Works Rights[18]. His government outlawed all trade unions and saw to it that they had virtually no role to play in negotiating workplace pay and conditions. He also reduced the right to freedom of speech. Singapore also has low taxes which is a flat rate of 15% and no other taxes such as capital gains tax[19]. Hong Kong was very similar to Singapore in that it is small physically, but Hong Kong remained a part of the English Empire until 1999. It had cheap taxes and limited democratic institutions[20]. Trade unionism had been limited as a result of the 1967 riots where unionist loyal to China caused riots and damaged infrastructure. Outlawed and ban from political life in Hong Kong, it was not until 1990's that the participants who took part in the 1967 riots where allowed to reenter politics.[21] This situation was highly beneficial for transnational corporations who wanted to maximize their profits and avoid dealing with trade unions.

In the 1960's and1970's the wages of the first world in comparison to the third world was substantial. By the 1980's first world nations realized they could not compete with former third world nation countries on labour costs[22]. If they did not do something they would lose all of the transnational

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[13] Klein, Naomi (2008). "3". *The Shock Doctrine*. Penguin. p. 55.
[14] Henry Wai-chung Yeung 2003 Managing Economic (In)security in the GlobalEconomy:Institutional Capacity and Singapore's Developmental State Paper Presented at the Conference on 'Globalisation and Economic Security in East Asia: Governance and Institutions', 11-12 September, 2003, Institute of Defence and Strategic Studies, Nanyang Technological University, Singapore.pp 7-10
[15] Cit Op n 15
[16] Rhys Jenkins Transnational Corporations and Uneven Development in the third world pp 131-136.
[17] Steve Forbes (2015)
[18] Cit op p 1
[19] Rhys Jenkins Transnational Corporations and Uneven Development in the third world pp 131-136
[20] Scott Ian. [1989] (1989) Political Change and the Crisis of Legitimacy in Hong Kong. University of Hawaii Press pp 100-112
[21] ibid p100
[22] J. F. Ermisch and W. G. Huff, "Hypergrowth in an East Asian NIC: Public Policy and Capital Accumulation in Singapore", World Development Vol. 27 No. 1, 1999, p21.

corporations. Many of these governments were noticing how these once poor nations were expanding into industries other than manufacturing such as the financial sector[23].

During the 1980's and 1990s Australia responded by removing tariff controls and also moving away from a centralized industrial relations system to enterprise bargaining. This change of policy led to a closer convergence of wages paid to workers in the first world compared to Singapore and Hong Kong. Even to this day Australian wages are still higher but the gap has narrowed considerably[24]. Singapore and Hong Kong ultimately succeeded in having an open economy without tariff barriers or strong industrial relations. Their strategy was to entice the transnational corporations with subsidized cheap labor and very low taxes whilst at the same time a government department would develop infant industries that would expand in their operation over a period of time[25]. Many of these industries were supported by government grants and funding. Once these countries had developed their own manufacturing industries they would expand into other sectors such as finance sector. This has been the case with both Singapore and Hong Kong who are no longer involved in low skilled manufacturing of goods because it is cheaper to go China or any other country which has a cheap pool of labour[26]. The first world nations are still seeking to reduce the cost of doing business by limiting the growth of wages and controlling the bargaining power of trade unions. However, the gap is narrowing between the first world and the third world. One consequence is that as the price of labour must be cheaper for the transnational corporations to maximize profits[27]; this has the potential to cause transnationals to source products from dubious operators, who may use forced labour to manufacture goods. This will only increase in the future as corporations seek to increase profits.

The New Wave of Industrialisation

Today transnational corporations have moved to Bangladesh and Myanmar where labour is cheaper than before than ever before. The paper will now consider Bangladesh and Myanmar and how these countries have been used by corporations to make a quick profit. Both countries have been in economic turmoil for many years and, unless there is a massive turn around, it is unlikely that both nations will ever be like other nations who used this strategy to make their countries into economic powerhouses.

Both of these countries had dictatorships and were under military rule for a certain period of time. They have both experienced severe poverty. Another issue is that both countries lack governments which have the entrepreneurial skills of Singapore and Hong Kong. In addition, Bangladesh and Myanmar are considered very corrupt by world standards[28] Working conditions are very bad with poor ventilation, and very little pay which can be as low as $20 for 19 hours of work.
During the early 2007 Bangladesh began to establish itself as a manufacturing hub for textiles and clothing with all the international fashion labels throughout the world but was heavily dependent on forced labour. Companies included Marks & Spencer, Nike, Walmart Gap and Victoria Secret have used forced labour in Bangladesh[29]. For example, Nike in the 1990's was caught by consumer rights groups using child labour. Nick has long been strong advocate for workers' rights and now claims that it has an ethical policy of not using forced labour. In an interview, asked if Nike still uses forced labour, Nike CEO 'Todd McKean admitted that the company's attitude was "we don't own the factories, we don't control what goes on in there."

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[23] Garry Rodan, Singapore's 'second industrial revolution': State intervention and foreign investment, ASEAN Australia Economic Papers No. 18, 1985, pp14- 35.
[24] Gary Bank (2004) 'Structural reforms Australian style: lessons learnt for others, Australian Productivity Commission: pp 1-38
[25]Ibid p 6
[26] Cit op n25 p 15
[27] ECD Glossary of Statistical Terms - Wages and salaries - SNA definition". OECD. July 19, 2002
[28] http://news.bbc.co.uk/2/hi/south_asia/4353334.stm and also see
[29] David MacIntyre (2014), '10 Major Clothing Brands Caught in Shocking Sweatshop Scandals: http://www.therichest.com/rich-list/most-shocking/10-major-clothing-brands-caught-in-shocking-sweatshop-scandals/?view=all

Likewise Walmart, denied any involvement in manufacturing clothing using forced labour in Bangladesh as this would be against the ethical rules that the company espouses. However, it was later discovered that clothing for the company was produced in Bangladesh where they were only paying $20 per month per employee for a 19 hour shift.[30] In 2012 a fire started at Tazreen Fashion factory which employed 1630 employee in a very small factory with poor ventilation and fire escapes. During the fire the owners left the workers trapped in the poorly maintained building. At least 117 were killed and 200 serious injured[31]. The publicity from the fire caused the corporations to move to Myanmar where wages are cheaper and human exploitation is far worse than Bangladesh.

As one can see Bangladesh and Myanmar have no chance of using transnational corporations to improve their living standards as has been the case in Singapore or Hong Kong. Bangladesh is an example of the new wave of industrialization where the company and its consumers live in another part of the world. When their goods are made by a third party it is difficult to trace links back to the fashion labels. It also an environment where the pay and working conditions are poor and workers die. There are no ready solutions. Today, with 21 million people being exploited though being put into forced labour, the UN and ILO need to revisit the decision of the 1970s, i.e. for the ILO to reverse the decision not link Human Rights to workers' rights. Unless this is done, more of the world's poor will find themselves in poverty and being exploited and placed into force labour.

Only with exposure of the conditions of their operations, as was the case of Bangladesh, will transnational organizations change their operations. Alternatively, they face the consequences of consumer boycotting their goods which will affect their ability to maximize their profit.

[30] Farid Ahmed (25 November 2012). "At least 117 killed in fire at Bangladeshi clothing factory". CNN. Archived from the original on 25 November 2012. Retrieved 25 November 2012.bid

[31] ibid