

THE SHAREHOLDER WEALTH
MAXIMIZATION NORM AND
INDUSTRIAL ORGANIZATION

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**THE SHAREHOLDER WEALTH MAXIMIZATION NORM
AND INDUSTRIAL ORGANIZATION**

MARK J. ROE[†]

ABSTRACT Industrial organization affects the relative effectiveness of the shareholder wealth maximization norm in maximizing total social wealth. In nations where product markets are not strongly competitive, a strong shareholder primacy norm fits less comfortably with social wealth maximization than elsewhere because, where competition is weak, shareholder primacy induces managers to cut production and raise price more than they otherwise would. Where competition is fierce, managers do not have that option. There is a rough congruence between this inequality of fit and the varying strengths of shareholder primacy norms around the world. In Continental Europe, for example, shareholder primacy norms have been weaker than in the United States. Historically, Europe's fragmented national product markets were less competitive than those in the United States, thereby yielding a fit between their greater skepticism of the norm's value and the structure of their product markets. As Europe's markets integrate, making its product markets more competitive, pressure has arisen to strengthen shareholder norms and institutions.

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THE SHAREHOLDER WEALTH MAXIMIZATION NORM AND INDUSTRIAL ORGANIZATION

MARK J. ROE

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INTRODUCTION

I make a single, simple point in this paper: the relative value of shareholder wealth maximization for a nation is partly a function of that nation's industrial organization. When much of a nation's industry is monopolistically organized, maximizing shareholder wealth would maximize the monopolist's profits, induce firms to produce fewer goods than society could potentially produce, and motivate firms to raise price to consumers beyond that which is necessary to produce the goods.

I. SCOPE

A few words on scope: I do not specify here the source of shareholder primacy norms. These norms could come from culture, from institutions, or from rules. Nor do I focus on what does the work: the norm or the underlying institutions and rules. I instead focus on the fit between the norm (or its underlying institutions and rules) and industrial organization.

Disentangling norms from practices is not easy. It would be odd for a nation to have norms sharply differing from practices, institutions, and laws. Because norms are usually congruent with practices, institutions, and laws, knowing which element is critical is hard.

Another limit to the paper: I have nothing here to say on the absolute value of a shareholder primacy norm. It may be so critical for organizing large private firms so that even where it fits badly with industrial organization, it is nevertheless worth pursuing. Or it may so diminish total social wealth (a minority view today) that it isn't worth pursuing single-mindedly anywhere. Or it may be so brutal if pursued single-mindedly that no organization and no society can absorb it in its pure form. Perhaps the norm must be softened to survive.¹ I instead make the point that its relative

¹ Cf. Mark J. Roe, *Backlash*, 98 COLUM. L. REV. 217 (1998) (analyzing how an otherwise efficient rule might create social turmoil).

value depends on industrial organization, and that there is a rough congruence around the world with this relative value.

II. THE UTILITARIAN BASIS FOR SHAREHOLDER WEALTH MAXIMIZATION

The prevailing academic and business view in the United States is that shareholder wealth maximization fits with a utilitarian, greatest-good-for-the-greatest-number philosophy in the competitive United States. But a nation with concentrated industry might not be as well served by strong shareholder wealth maximization institutions.

Shareholder wealth maximization is usually accepted as the appropriate goal in American business circles.² The norm though makes some uneasy: after all, why should shareholders, who usually are favored members of their society, prevail over, say, current employees, who usually are less favored?

The utilitarian justification is that this is the price paid for strong capital markets and allocative efficiency, and that these benefits are so powerful that they overwhelm the normative benefit of any distributional favoring of current employees over current shareholders.

In the long run, the argument goes, employees and other stakeholders are overall better off with fluid and efficient capital markets, managers need a simple metric to follow, and both wealth and, in the end, fairness are maximized by shareholders being the corporation's residual beneficiary, with the other claimants getting what they want via contract with the corporation. Current employees might be made worse off in some industries, but employees overall would have more opportunities, higher salaries, and better working conditions. Furthermore, a stakeholder measure of managerial accountability could leave managers so much discretion that managers could easily pursue their own agenda, one that might maximize neither shareholder nor employee nor consumer nor national wealth, but only their own.

But that sketch is weaker in a nation with mostly concentrated industry and weak product market competition. Enhancing shareholder wealth maximization in that kind of a national economy may, even if the baseline utilitarian argument is correct, *reduce* national well-being, as we next see.

² See, for example, the famous essay by Milton Friedman, *The Social Responsibility of Business Is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970, Magazine, at 33. Although aggressive when it appeared, Friedman's perspective is now mainstream in American business circles and was not unthinkable then (as it was in some other nations). Cf. Michael E. Porter, *The Microeconomic Foundations of Economic Development*, in WORLD ECONOMIC FORUM, THE GLOBAL COMPETITIVENESS REPORT 1998 38, 42 ("In western Europe . . . the inability to place profitability as the central goal is . . . the greatest constraint to economic development.")..

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III. SHAREHOLDER WEALTH MAXIMIZATION AND MONOPOLY RENTS

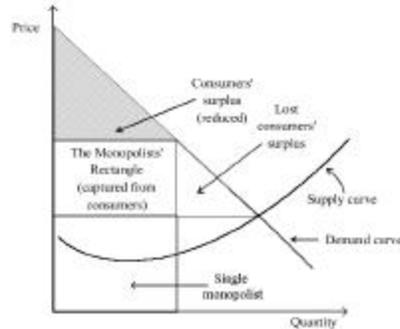
A. Shareholder Primacy Could Diminish GNP if Industry Is Concentrated

Consider the monopolist's discretion. In Graph 1, a stripped down version of the basic supply-demand setting for a monopoly, the monopolist can restrict production, raise price, and maximize its monopoly profit by finding the price-quantity combination that makes the "rectangle" (and, hence, its profits) as big as possible.

The monopolist could, if it wanted to, produce the amount that a competitive industry would produce. If it did so, it would not be maximizing its own wealth, because it would be leaving that "rectangle" of profits on the table. The consumers' triangle would be maximized. The monopolist would also, incidentally, usually employ more people as production would rise compared to the constricted production when monopoly profits are maximized. It would maximize the nation's wealth, not its own.

A strong shareholder wealth maximization norm will induce the monopolist's managers to *lower* production, to *raise* prices, and to *lower* employment. Weaker shareholder primacy norms could (plausibly but not necessarily) increase national wealth in a nation with highly concentrated industry.

Weaker shareholder primacy institutions could induce the firm to move down the demand curve, producing more and lowering price. This point is consistent with a standard view on agency costs: If unconstrained managers usually prefer to build larger firms, if they usually prefer to build new factories, and if they usually prefer sales to profits—all of which are typically the core managerial agency costs to shareholders—then they are *more* likely in a concentrated industry with weak shareholder wealth maximization to travel down the demand curve by first producing more and then concluding that they cannot aggressively raise price. The weakly controlled managers could produce more national wealth than the tightly



Graph 1: Monopoly: The Lost Consumers' Surplus and the Monopolists' "Rectangle"

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controlled ones.³

To be sure, this increase in social wealth, while a plausible effect of weakened shareholder primacy in a monopoly, is not its only possible effect. Most obviously, loosening constraints on managers may just mean that the managers take more for themselves rather than increase production. One could, however, imagine a society with weak shareholder primacy norms but strong anti-theft institutions: Managers are precluded from taking for themselves but are not instructed as to what they can do with the potential pot of monopoly profits. When incentives and markets are weak, they have discretion. Even here there is ambiguity. In the United States, “managers taking more for themselves” has led to higher salaries, more perks, and bigger but less profitable empires, all of which have generally negative social effects when product markets are competitive. But when product markets are uncompetitive, the firm that expands to produce more could be socially positive, assuming the empire is not an unproductive one.

Conversely, managers on a short leash might stay at the same point on the demand curve, but economize more on resources if they must maximize shareholder wealth. Economizing inputs tends to offset the maximizers’ reducing output. In an economy with widespread monopoly, some firms encouraged to maximize shareholder wealth would primarily economize, while others would slash production and reduce allocative efficiency. One cannot predict which effect would dominate.

More subtly, *ex ante* incentives would diminish if, after a monopoly was acquired, institutions, rules, and norms weakened the shareholders’ profits. Which effect—the negatives of incentive effects and managerial grabs of the rents versus a better *ex post* allocative efficiency—would dominate is *a priori* uncertain. Hence, nations with concentrated industries and many monopolies and oligopolies have reason to be less enthusiastic about, and conceivably even to denigrate shareholder primacy (depending on which effects—incentives and reducing waste or allocative efficiency—they predict would dominate).⁴ Historically, the ambiguous balance was

³ Cf. JOHN KENNETH GALBRAITH, *THE NEW INDUSTRIAL STATE* 183 (1967) (discussing the contradictions in conclusions reached by market theorists on the efficiency of the market and the need for regulatory reform); THORSTEIN VEBLÉN, *THE ENGINEERS AND THE PRICE SYSTEM* 70-71 (1936) (noting that a “free hand” for managers would increase production).

⁴ The proposition can be stated more formally: Imagine Nation A, a nation with competitive markets whose corporate law standard is that managers maximize national wealth, and a Kaldor-Hicks economic efficiency standard. In a shareholder suit, managers concede that they were not managing shareholder profits. In Nation A’s competitive market, they were therefore failing to maximize not only shareholder wealth but also societal wealth. They should lose. Imagine Nation B, a nation without competitive markets, where the corporate

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strongly in play in Continental Europe where monopolies were more widespread, but weakly in play in the United States where they were less widespread.⁵

B. *The Ambiguity of Pro-employment Corporate Governance Policies*

Employees of monopoly firms can, and do, ally with capital to split the rents, to facilitate constricting production and raising price, and to seek barriers to competitive entry. That is, employees whose jobs are already set and secure often represent *themselves*, not the whole labor pool of all potential employees; some of those in that labor pool could be employed but are not, or are employed in less desirable jobs because the monopoly limits production and opportunity.

So, start here with the monopoly in Graph 1. Once the monopolist's employees gain a secure share of that rectangle, they become uninterested in policies that would move the firm down the demand curve to a lower price and higher production because that would reduce the size of the rectangle (out of which the employees get some of their higher-than-typical wages and benefits) and, in turn, would thereby put downward pressure on the employees' wages and benefits. This much is understood.⁶

But consider the consequences of a supply shock to the industry. The cost of a critical input, say oil, rises dramatically. Usually the shape of the demand curve induces the monopolist to cut production further and lay off employees. That is, if a cost rises, the monopolist will often "pass it, or

law standard is that managers maximize national wealth. In a shareholder suit, managers state that they failed to maximize shareholder wealth, but were maximizing the firm's total sales, to the point where the revenues from the last sale equaled the costs of making that sale. Under a shareholder primacy test, such managers would lose; but under a national wealth test they would win. Below, I suggest that it may be no accident that continental European nations have not had a strong shareholder primacy standard. *Infra* Part IV.

⁵ In the longer-run, this anti-shareholder story as creating wealth weakens. This is because such anti-shareholder societies can eventually deter private savings, and a savings decline would affect overall welfare. (Ironically, such anti-shareholder wealth maximization would be socially satisfactory in the short-run but not in the long-run. The irony comes from the usual cliché that maximizing shareholder profits is a short-run strategy.) More precisely, consider an economy in which the competitive rate of return on capital was 10%, and the monopoly initially yielded 30%. If the anti-shareholder institutions only halved profitability in the monopoly industries, capital would still be forthcoming because politics still left the *competitive* rate of return on the table. But if politics took profitability below the competitive risk-adjusted 10%, savings would diminish and capital would take flight to other less anti-shareholder nations.

⁶ See, e.g., Nancy L. Rose, *Labor Rent Sharing and Regulation: Evidence from the Trucking Industry*, 95 J. POL. ECON. 1146, 1148, 1175 (1987) (finding that union workers in the trucking industry gained part of the rents from weak competition).

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most of it, along” to the consumer, raising prices, cutting production, and laying off some workers.⁷

Consider the monopolist in a nation that denigrates shareholder wealth maximization and has rules and norms that discourage lay-offs. Employees cannot easily be laid off. Their jobs cannot be radically reconfigured without their consent. As such, the monopolist might *not* cut production and raise prices further, despite the shareholder-wealth-maximization basis for doing so, because it must pay the employees anyway if labor markets are rigid and if it cannot costlessly redeploy its workforce.⁸ In such circumstances, not only are the employees with jobs protected, but national wealth is increased (or at least not decreased) by slack agency controls on managers. A weak shareholder primacy norm facilitates greater production and, here, greater allocative efficiency. (To be sure, *prior* to the monopoly arising, employees with jobs at the potential monopoly firms would *like* the firm to have monopoly profits, as then they can share in some of the rents. In this post-monopoly setting, they prefer that some of the monopoly profits be dissipated on keeping themselves employed. Ex post and ex ante attitudes to the monopoly results differ.)

This is not just an abstract possibility. Detailed industry studies show that when German and American firms faced exchange rate pressures, German firms absorbed the cost, that is, shareholders shouldered the loss. Similar American firms passed it on, thereby risking that their higher prices would lead them to lay off employees and down-size, that is, employees bore more of the risk.⁹ Presumably the American firms did not absorb these costs because they were in a more competitive market and could not absorb the increased costs.

⁷ Cf. Kim B. Clark, *Unionization and Firm Performance: The Impact on Profits, Growth and Productivity*, 74 AM. ECON. REV. 893, 898-99 (1984) (noting that greater industrial concentration allows a monopolist to pass union wage increases forward to consumers).

⁸ One could consider this scenario to be shareholder wealth-maximization inside constraints. But this scenario can play out in two ways: labor rules might constrain the owners from laying off the workers or corporate laws and institutions could weaken shareholder wealth maximization. The first is shareholder wealth maximization within constraints, the second is not.

⁹ Michael Knetter, *Price Discrimination by U.S. and German Exporters*, 79 AM. ECON. REV. 198, 205 (1989). Cf. Michael A. Salinger, *Tobin's q, Unionization, and the Concentration-Profits Relationship*, 15 RAND J. ECON. 159, 166 (1984) (concluding that either “there is little long-run monopoly power in the U.S. economy” or any such power is captured by an industry input such as unionized labor).

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C. *Why Not Both?*

One could imagine a nation seeking shareholder wealth maximization within constraints. That is, the nation's polity might constrain firms from laying off employees, but within those bounds, its rules and norms could allow or even encourage firms to maximize shareholder wealth in the belief that maximizing it will economize on resources and promote national wealth after basic fairness is assured.

This combination is uncommon for at least three reasons. First, maximizing within constraints does not necessarily maximize social wealth when product competition is weak;¹⁰ some public policy-makers may understand this.¹¹ Second, bright-line fairness and job security constraints are often hard to write down in a law and enforce, since the boundaries are hard to define: When are layoffs justified? When are they unjustified? Who judges when they are justified? Weak shareholder wealth norms and institutions plausibly could better operationalize the core goals of such a society that sought to favor employees. Third, political parties that constrain the firm (with pro-employee rules) often have complementary anti-shareholder ideologies; protecting jobs in place *and* denigrating shareholder value are an ideological (and public choice, interest group) package; political parties seek both, not one or the other, and, if a party achieves power, it implements both.¹²

¹⁰ See *supra* note 7 and accompanying text.

¹¹ High monopoly rents throughout the economy create two related cross-cutting effects: First, the potential for agency costs in the monopoly firms rise because the pot of monopoly money is up for grabs. Owners react by seeking to contain the profit loss, often keeping concentrated ownership because they cannot trust managers when monopoly profits make agency costs very high. Second, public policy-makers who are looking out for the broad public have little reason to foster shareholder wealth maximization institutions.

¹² One could similarly imagine less competitive nations trying to directly force monopoly firms to increase production. This they sometimes do, but usually via government ownership of the firm, or via price regulation. Antitrust policy obviously plays a role here: when successful in anchoring competition (perhaps because the underlying conditions in the economy facilitate success), shareholder primacy can play a larger role.

The point here is not that the antishareholder authorities are crisp in their thinking and policies. (And shareholder wealth maximization norms and institutions are also denigrated in nations with highly competitive markets, although denigrated less vociferously.) I do not think that public players have rigorously thought through the relationship, although a few surely have the intuition. The point is more that weak shareholder norms fit, and perhaps are less likely to be challenged, in a weak competition environment.

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D. *Proviso: Who Pays for That Transferred Rectangle and That Lost Triangle?*

Thus far I have focused on market structure in a national economy. In such a setting, shareholder wealth maximization norms and supporting institutions may decrease national wealth because the monopolist seeking to maximize profits would destroy more consumer value than the one with weak profit goals. For some small nations, however, the relevant consumer pool (whose wealth the monopolies are reducing) is not domestic but international.

So, now change our assumption of monopoly firms selling into a domestic market. Assume that the monopolistically organized industries export heavily to neighboring nations. Then some portion of the monopolist's rectangle comes from foreigners, and some part of the diminished consumer's surplus triangle is lost to foreign consumers. If the policy choice is binary, the locally rational decision is to *maximize* monopoly profits at the expense of foreign buyers.¹³ Shareholder wealth maximization is not *general* wealth maximization (because foreign buyers are made poorer), but it is local wealth maximization.

IV. DELIBERATELY WEAKENING SHAREHOLDER WEALTH MAXIMIZATION

Corporate governance institutions tend to match the underlying organization of industry. Some of these institutions are legal, some economic, some cultural. A few examples follow of the differing strength of shareholder institutions.

A. *Corporate Law's Standards*

Section 2.01 of America's core academic aspiration for corporate law tells the firm's managers: "a corporation . . . should have as its objective the conduct of business activities with a view to *enhancing corporate profit and shareholder gain*."¹⁴ The analogous corporate law commands in continental Europe differ.¹⁵ French corporate law allows managers, it is said, to manage

¹³ Sometimes the local monopoly can price discriminate by charging the monopoly price internationally and a lower price domestically.

¹⁴ PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(a)(1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE] (emphasis added).

¹⁵ Philippe Bissara, *Les Véritables Enjeux du Débat sur 'Le Gouvernement de l'Entreprise'*, REVUE DES SOCIÉTÉS, Jan.-Mar. 1998, at 5, 15 ("In France, as in most continental European nations, the social interest is the directors' 'compass'").

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their firm in the social interest.¹⁶ German law refuses to tell managers that they are their shareholders' agents. This tendency has been part of a long tradition of refusing to endorse shareholder primacy,¹⁷ and Germany has labor strongly represented on the large firm's supervisory board. Indeed, German commentators (more authoritative there than are U.S. commentators here) state that German directors *cannot* act "only in the interests of the shareholders."¹⁸ The fit of the differing national corporate law standards with the product market analysis thus far is obvious.

I do not mean by this that corporate law's instructions to managers determine what they do. The means by which managers can undo this instruction are many: the American business judgment rule vests them with enormous, nearly unreviewable discretion; monetary incentives, if lacking, could overwhelm any of law's rhetorical instructions; and America's corporate law itself has more than a little undertow via its authority to account for ethics¹⁹ and, in reaction to hostile takeovers, to account for stakeholder constituencies. International differences in corporate law's standards are the beginning, not the end.

B. *Rhetoric and Culture*

The rhetorical pressure goes beyond law. Norms in American business circles, starting with business school education, emphasize the value, appropriateness, and indeed the justice of maximizing shareholder wealth (which will trickle down, or raise the tide that will raise all boats, etc.). In France and Germany, shareholder wealth maximization is demeaned and seen as at odds with social values. And in Japan, senior managers rank shareholder profit maximization (more precisely: return on investment and

¹⁶ See Christiane Alcouffe, *Judges and CEO's: Aspects of French Corporate Governance* (April 1999 working paper) ("French law, judges, and CEO's use the notion of 'social interest' [differently]. The judges [use it] to guarantee the continuity of the firm, especially when [it] faces economic difficulties, [while] the CEO's refer to it to keep a free hand in managing the company. Shareholders see [it] as [an] ambiguous [notion,] mostly used against their own interest.").

¹⁷ See Klaus J. Hopt, *Common Principles of Corporate Governance in Europe?*, in *THE COMING TOGETHER OF THE COMMON LAW AND THE CIVIL LAW* 106, 118 & n.52 (Basil S. Markesinis ed., 2000).

¹⁸ Arndt Stengel, *Directors' Powers and Shareholders: A Comparison of Systems*, *INT'L COMPANY & COM. L. REV.*, No. 2, at 49, 51 (1998), citing Hoffmann-Becking, in *MÜNCHENER HANDBUCH DES GESELLSCHAFTSRECHTS*, tome 4 Aktiengesellschaft, s. 33 n.3 et seq.

¹⁹ See *PRINCIPLES OF CORPORATE GOVERNANCE*, *supra* note 14, § 2.01(b)(2)-(3) & rep. note 5.

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stock price) much lower than do American managers.²⁰

Well-to-do families in some nations are said to prefer family ownership of enterprise. Firms are passed from generation to generation; corporate governance sometimes becomes the governing of family relationships. While this cultural preference may well be a fully independent dimension to the organization of business and politics, note the fit between this cultural preference and high rents. The preference is “functional” (for shareholders) in that such family structures can keep more of the rents inside that family than can another structure. It can be seen as a natural reaction when shareholder wealth institutions are weak, making a separation of ownership from control more precarious for shareholders than where they are strong. (Or, reversing causality but keeping the fit: weak shareholder primacy institutions may fit when ownership is close anyway, as the dominant stockholders can look out for themselves.) An American culture of a founder’s quick sale of her successful firm fits better with an economy with few rents (and with stronger shareholder primacy institutions and norms).

C. Hostile Takeovers

In the 1980s, about thirty percent of America’s Fortune 500 companies received takeover bids.²¹ This is an extraordinary number, indicating that shareholder power via takeover bids had to be on the minds of all large firm managers. The 1980s were also, consistent with the thesis here, arguably one of the periods of strongest product market competition. Not only were American manufacturing markets workably competitive, but international competition was, for essentially the first time, pounding every manufacturer that could not perform. Hostile takeovers were, and despite the rise of the poison pill still are, an engine of shareholder wealth maximization.

In Europe until recently, hostile takeovers (and indeed any takeovers) were denigrated. The few hostile takeovers tried in Germany foundered (until the Vodafone takeover in 2000), often due to political pressure, as

²⁰ Merton J. Peck, *The Large Japanese Corporation, in THE U.S. BUSINESS CORPORATION: AN INSTITUTION IN TRANSITION* 21, 33-37 (John R. Meyer & James M. Gustafson eds., 1988). The Japanese managers’ pursuit of other goals could still result in adequate profit maximization. Cf. Steven N. Kaplan & Bernadette A. Minton, *Appointments of Outsiders to Japanese Boards: Determinants and Implications for Managers*, 36 J. FIN. ECON. 225 (1994) (finding that appointments of outside directors increase with poor stock performance or earnings losses); Steven N. Kaplan, *Top Executives, Turnover and Firm Performance in Germany*, 10 J.L. ECON. & ORG. 142 (1994) (exploring similar relationships in Germany).

²¹ John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 851 (1999).

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workers campaigned to block the takeovers and politicians sided with employees and against the capital owners.²² In one major attempt, in the steel industry, the nominally *conservative* German chancellor said he was ““deep[ly] concern[ed]”” over it, asking the firms and players to ““live up to their social responsibilities.””²³ They substantially cut back their planned restructuring.

The French Minister of Finance has been suspicious of high-priced takeovers, because, he said when deterring one such high-price offer in 1998, the ““high [stock] price means the buyer would have to look immediately at higher profits to pay for the acquisition, which could be negative . . . for jobs.””²⁴ Until 1999, the state often decided takeover results and, even when it withdrew from overall control, it continued to seek to avoid takeovers that would yield ““a social massacre”” with ““massive layoff[s].””²⁵ The French ministers proposed a takeover law in March 2000 that would require an offering company to agree on some terms with the *employees* of the target. ““A takeover could not succeed without taking into account employees’ views,”” said the French Finance Minister, seeking to formalize what had been an informal policy.²⁶

Only recently, as European governments were moving to the right economically and product markets have become more competitive, have hostile offers appeared; historically they occurred in continental Europe at a rate far lower than that prevailing in the United States.

²² See Richard Halstead, *Steel Is Put to the Sword*, THE INDEPENDENT (London), Mar. 23, 1997, at 3 (“The combined forces of federal economics minister Guenter Rexrodt and Johannes Rau, premier of North Rhein Westphalia, Germany’s biggest state, bounced Germany’s virtually sole corporate raider into ‘negotiations’ with Thyssen” for a smaller merger on terms favorable to incumbent employees); *Steeled for a Battle*, FIN. TIMES (London), Mar. 22, 1997, at 9 (reporting a mainstream German newspaper headline asking if an executive seeking a takeover wanted to set Germany on fire); Michael Woodhead, *A Pyrrhic Victory for Germany*, SUNDAY TIMES (London), Mar. 30, 1997, § 3, at 7, col. 1 (“The foiling of Krupp’s bid for Thyssen is a victory for the social consensus.”).

²³ William R. Emmons & Frank A. Schmid, *Universal Banking, Control Rights, and Corporate Finance in Germany*, FED. RES. BANK OF ST. LOUIS REV., July/Aug. 1998, at 19, 22.

²⁴ Alan Katz, *Shareholders Gain Voice in France, But Socialist Tradition Talks Back*, WALL ST. J., Feb. 13, 1998, at B7E. A high price might indicate high inefficiencies, perhaps including redundancies in the work force.

²⁵ Martine Orange, *La fin de l’exception française?*, LE MONDE, Mar. 30, 1999, at 19.

²⁶ Frédéric Pons, *Un brin d’éthique dans les fusions*, LIBERATION, March 16, 2000, at 25; see Thomas Kamm, *French Bill Takes Aim at Takeovers In Wake of Recent Merger Battles*, WALL ST. J. EUROPE, Mar. 16, 2000, at 2 (describing the takeover bill).

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D. Incentive Compensation

Stock-based incentive compensation could induce managers to maximize shareholder wealth. Studies of incentive compensation show that French, German, Italian, Swedish, and other Continental European managers receive lower incentive compensation than American managers, and that the incentive compensation they do receive is typically a much smaller fraction of their total pay.²⁷

Stock options have been less widely used in Europe. Partly this has been because stock options were disfavored in tax terms, and presumably much of this tax result came from an anti-shareholder perspective. Stock options have also been disfavored because options would further separate managers from employees, something that European culture sees as having an unethical edge.²⁸

V. CAN STRONG CAPITAL MARKETS EASILY OVERCOME WEAK PRODUCT MARKETS?

One might think that capital markets must induce shareholder wealth maximization even if product markets are weak. This is incorrect, however.

A simple explanation is that the two tend to move together, so disjunction (one strong, the other weak) is an odd result. But even if capital markets are strong and product markets weak, capital markets will not trump the weak product markets and induce strong shareholder results.

A. Raising New Capital

Capital markets constraints on managers are weaker when product competition is weaker. Consider how capital market competition constrains managers: Managers must go to capital markets for funds and, when they do, stock-buyers penalize poorly-performing managers by demanding a higher rate of return and a lower stock price; creditors penalize those managers by demanding a higher interest rate; and at the limit, capital-providers refuse to give those managers any new capital. In the latter case,

²⁷ TOWERS PERRIN, WORLDWIDE TOTAL REMUNERATION 24 (1999)

²⁸ See Peter Goldstein, *Managers & Managing: Compensation Packages for Executives Aren't All Alike—Base Pay Converges in Europe, but Bonuses and Stock Options Vary*, WALL ST. J. EUR., Dec. 22, 1998, at 4 (noting that in some countries, “options aren’t considered entirely ethical”); see also Graham Bowley, *Hoechst Launches Stock Option Scheme*, FIN. TIMES, Sept. 13/14, 1997, at 19 (“Only a handful of Germany’s biggest companies have adopted share option schemes, which differ from those in the US and UK because of strict German regulations on employee share ownership.”).

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the firm withers. More effective firms with more effective managers eventually replace it.

But the capital market constrains the *monopolist's* managers less strongly than it constrains a competitive firm's managers. Often the monopolist's managers can generate sufficient profits internally to pay for needed capital improvements. And as long as they leave *some* of the monopolist's "rectangle" on the table for the original capital providers, the monopolist's return on invested capital will *still be higher* than that of a competitive firm. Capital markets constrain the monopolist's managers strongly not when the managers are dissipating any monopoly profits, but when the managers go further *and dissipate so much that the return dips below the competitive return for capital.*²⁹ Until then, managers are constrained only weakly by capital markets.

Thus, if the monopoly rate of return is, for example, 30% when world-wide capital markets demand a 10% rate of return (for this type of company, this class of risk, etc.), then capital markets constraints might strike the firm dead if managers throw away enough that the expected return declines below 10%. But capital markets will not directly constrain the managers as they take, share, or squander 20% of the monopoly's return. That 20% cushion is the monopolist's rectangle, the potential excess profits that create the potential for slack.

B. Takeover Markets

Takeover markets constrain managers, but they do not do so fully. Even when they add to constraints on managers, they do not substitute fully for competitive markets.

Consider the typical premium in takeovers, which approximates 50% of

²⁹ The capital markets mechanism would, in textbook fashion, be this: When the firm goes fully public, investors would capitalize the firm's expected cash flows. These cash flows will be the competitive return, plus the additional monopoly profits before agency costs, minus the monopoly profits lost due to agency costs. The original owner reaps the expected gains from the monopoly and any expected losses from managerial agency costs. Unexpected reductions in agency costs will be captured by future shareholders. The non-classical point to be made here is that if the potential agency costs are high for a monopoly firm, then the original owner will often decline to allow the firm to go public to avoid the expected loss.

So, if the competitive rate of return is 10%, but the firm earns \$30, not \$10, on its investment of \$100, the original owner will be able to sell the firm for \$300, if agency costs would be nil. If agency costs would diminish earnings to \$25, then the original owner will be able to sell for \$250. If the original owner values the gains from going public (in diversification, liquidity, change of work plans, etc.) at less than \$50, he or she will keep the firm private.

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the pre-takeover trading price of the stock. Posit that competitive markets ordinarily keep managers from straying more than 25% away from maximizing shareholder profitability. That would mean that when markets are uncompetitive, there is an additional 25% of slack in shareholder wealth that managers are accorded, before takeovers kick in to constrain them from further straying from shareholder profitability. More plausibly, we have a series of overlapping, but partial constraints; removing one increases the slack in most, although not all, firms. For some firms, takeover markets constrain as strongly as does product market competition, making each substitute for the other. But for other firms one constrains more strongly, such that loosening the stronger constraint does cut managers more slack.

Moreover, these same societies that have weak product market competition have reason to be reluctant to facilitate those takeovers, which would tighten up shareholder profitability, plausibly inducing higher prices and lower production. Many of these countries have discouraged takeovers.³⁰

C. Capitalization of Monopoly Profits

Capital markets will bid up the stock price until the return equals the risk-adjusted competitive return. Posit that the competitive, risk-adjusted rate of return is 10% annually. In competitive industries, \$100 of investment will return \$10 each year. A monopolist builds, with a \$100 investment, a monopoly that yields \$30 annually. When the monopolist sells the firm to buyers who expect the monopoly to be retained, the buyers will pay \$300. The *original* monopolist captures the \$200 “rectangle.” If agency costs are expected to diminish the firm’s profitability to \$25 (i.e., leaving \$15 of monopoly profits for capital-providers but dissipating the other \$5), then outsiders will pay \$250 for the firm.

True, managers in these now diffusely held firms have the usual reasons to want to increase the firm’s profitability from \$25, to the \$30 level that is attainable. They might do so. But capital markets do not necessarily force them to: The managers can raise capital, if they need to, so capital markets’ strongest weapon does not punish them. The typical 50% takeover premium needed means that an outsider would probably not mount a takeover (even if the society allows one), because the slack only justifies a 20% premium.³¹

³⁰ See *supra* Part IV.C.

³¹ A third theoretical capital market constraint is worth mentioning: When the monopolist leaves the firm, she could conceivably capitalize the firm (nearly) entirely with \$300 of debt, with an expected return of \$30. Cf. Michael C. Jensen, *Agency Costs of Free*

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VI. THREE AMERICAN IMPLICATIONS

One: American shareholder primacy institutions—always more or less strong—strengthened further when competition intensified in recent decades.

Two: What if the American economy is changing? What if monopoly, say in new technologies, is becoming more widespread? There is a trade-off, as there is for patents and monopoly analysis generally, of ex ante incentives vs. ex post allocative efficiency. If markets are competitive, there's good reason to weight ex ante incentives much more heavily than ex post allocative efficiency. And we weight ex ante incentives heavily in the U.S.—e.g., patent protection for twenty years. But we do give ex post allocative efficiency something on the scale: the patent after all expires; it doesn't go on in perpetuity. Some of this ex ante incentive vs. ex post allocative trade-off may, if monopoly once again becomes important, spill-over into debates about shareholder norms. When even patent-holding monopolies face some, albeit weak, competition, the trade-off in favor of ex ante incentives is easier to make than when the ex post allocative costs are very high.

Three: although I have here focused on one relationship—high monopoly rents fit less well with shareholder primacy than does a competitive product market—there is much more to the analysis: high rents also affect politics and corporate structure through other channels.

First, they affect corporate structure by raising managerial agency costs. They raise managerial agency costs because there is more for managerial agents to lose for shareholders, and several constraints on managers—product market constraints, obviously, but also usually capital markets constraints—are weaker in monopoly settings. Moreover, employees and other stakeholders will increase their demands on the firm, managers could more readily accede because the pot to divvy up is bigger, and these demands should further raise managerial agency costs. This pressure on the public firm via heightened agency costs helps to explain why there were fewer public firms in continental Europe. And, because the U.S. has historically been more competitive, it might help to explain the (relatively) easy time the public firm had in developing in the United States.³² As

Cash Flow, Corporate Finance, and Takeovers, 76 AM. ECON. REV. 323 (1986) (explaining that, according to the “control hypothesis” for debt creation, managers are constrained by the reduction of free cash flow resulting from the issuance of debt). The constraint on managers is that they must then scramble to meet the interest payment of \$30. To do so, they must capture the monopoly profits.

³² Cf. Mark J. Roe, *Political Preconditions to Separating Ownership from Control*, 53

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Europe's product markets have become more competitive, its demand for, or at least tolerance of, shareholder primacy institutions has also increased. This tolerance has made the public firm more plausible than it was previously.

Second, these rents can affect political structures. Conflicts in divvying up those monopoly profits can be widespread in a nation where monopoly is widespread. If widespread, these conflicts can spill over into politics, fuel political ideologies and political parties, and privilege quick government-led conflict resolution so that production can go forward. When an economy's product markets are more competitive, these conflicts diminish. Hence, the consequences of the conflict—political spillover, ideologies, and high demand for means that reduce conflict—also diminish.

I further develop these effects of high monopoly rents on the corporation, on politics, and on disfavoring the diffusely owned public firm (by raising managerial agency costs) elsewhere.³³

CONCLUSION

Maximizing shareholder wealth where competition is weak, therefore, could plausibly *reduce* production, *raise* prices, and *lower* national wealth, especially if managers when unconstrained value production, sales, and expansion over shareholder profits, as American agency-cost analysis usually concludes. (Or, because shareholder wealth maximization norms and institutions also induce economizing on resources and other positive incentives, where competition is weak, the norm doesn't raise production as much, doesn't lower price as much, and doesn't raise national wealth as much as it does where competition is strong.)

Hence, where industry is weakly competitive, shareholder wealth maximization norms and institutions are relatively less effective in raising social wealth than they are in more competitive economies.³⁴ And it would be a mistake to conclude that strong capital markets can trump weak product markets: if there is a world-wide return demanded by fluid capital at, say, 10%, then the monopolist who can potentially earn 30% has 20% of slack to keep for itself, to squander, or to share with other players in the system. The strongest capital market constraints do not kick in until the monopolist's managers squander, steal, or give away 20% of its profits.

STAN. L. REV. 539 (2000).

³³ Mark J. Roe, *Rents and their Corporate Consequences*, 53 STAN. L. REV. (forthcoming 2001).

³⁴ At least in the short, and maybe the medium, run. See *supra* note 5.

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Europe has tended both to have been less competitive historically and to have had weaker shareholder primacy norms and institutions than the United States has had. American shareholder primacy institutions—never especially weak in the first place—strengthened considerably as product market competition became more severe in recent decades. And in continental Europe, where national economies tended to have industry much more concentrated than it was in the United States and where pro-shareholder institutions tended to be denigrated, their weak shareholder institutions fit with their product market structures.³⁵ Whether or not Europe’s past of social democratic, anti-shareholder ideologies and institutions were wealth-maximizing (or the degree to which they were) depends on how the trade-off was made between gains from higher production and losses from more slack (ex post in weak controls and ex ante in weakened incentives), and on how uncompetitive its product market structure was.

³⁵ If information technologies create natural monopolies in the United States in a wide patch of the economy, the tight American fit of strong product competition and strong shareholder institutions could change. Cf. Paul Krugman, *Unsound Bytes?*, N. Y. TIMES, Oct. 22, 2000, § 4, at 15 (“The inevitability of monopolies in a knowledge economy . . . creates new puzzles for antitrust policy. The Microsoft case poses real dilemmas, and it is surely only the first of many.”).