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POLITICAL DETERMINANTS
OF CORPORATE GOVERNANCE:

POLITICAL CONTEXT, CORPORATE IMPACT

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Political Determinants of Corporate Governance: Political Context, Corporate Impact

Mark J. Roe*

ABSTRACT:

The claim I advance is that the large firm's ownership structure is too often analyzed as one arising solely from organizational imperatives and technical foundations. The political and social predicates that make the large firm possible and that shape its form can deeply affect which firms, which ownership structures, and which governance arrangements survive and prosper, and which do not.

To be concrete, much political analysis can be made to fit a principal-agent model. For ownership to separate from control, managers must be sufficiently aligned with shareholders. But the ways in which some polities settle conflict - or the ways in which the corporate players team up to work together - can affect the degree to which managers ally with shareholders and, concomitantly, how easy it is for ownership and control to separate.

Managers' agendas can differ from shareholders'; tying managers tightly to shareholders has been central to American corporate governance. But in other economically advanced nations, ownership is not diffuse but concentrated. It is concentrated in no small measure because the delicate threads that tie managers to shareholders in the public firm fray easily in common political environments, such as those in common in continental Europe in the late 20th century. Politics can press managers to stabilize employment, to forego some profit-maximizing risks with the firm, and to use up capital in place rather than to downsize when markets no longer are aligned with the firm's production capabilities; these political tendencies correspond closely to managers' historical tendencies, even in the United States. Since managers must have discretion in the public firm, how they use that discretion is crucial to stockholders, and common political pressures induce managers to stray farther than otherwise from their shareholders' profit-maximizing goals. Owners may be reluctant to turn the firm over to independent managers if managers would more willingly expand and make hard-to-reverse investments. The polity may refuse to give distant shareholders the tools that roughly align managers with shareholders, and it may denigrate the private means that align the two. And some of these political results are easily to implement in weakly competitive product markets, the kind of markets that give managers yet more discretion. Hence, public firms in such polities, all else equal, have higher managerial agency costs, and large-block shareholding has persisted as shareholders' best remaining way to control those costs. Indeed, when we line up the world's richest nations on a left-right political continuum and then line them up on a close-to-diffuse ownership continuum, the two correlate powerfully. True, the effects on total social welfare are ambiguous; such polities may enhance total social welfare, but if they do, they do so with fewer public firms than less socially responsive nations. These results strongly suggest that the corporate governance and ownership characteristics are linked, directly or indirectly, to basic political configurations in the wealthy West. European structures, for example, may link more tightly to Europe's late 20th-century politics than to technical institutions, and the technical institutions may derive from late 20th-century politics as much as anything else. We thus uncover not only a political explanation for ownership concentration in Europe, but also a crucial political prerequisite to the rise of the public firm in the United States, namely the weakness of social democratic pressures on the American business firm.

Keywords: corporate governance, ownership separation, securities markets, agency costs

Political Determinants of Corporate Governance

Political Context, Corporate Impact

MARK J. ROE

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PREFACE

The large business firm and its ownership structure is this book's general subject; the political impact on structure its specific focus. Too often the large firm's ownership structure is analyzed as a purely business institution, as one arising solely from organizational imperatives, technical foundations, and financial needs. The political and social predicates that make the large firm possible and that shape its form are not scrutinized as carefully, or at all, despite that variation in political and social conditions can deeply affect which firms, which ownership structures, and which corporate governance arrangements survive and prosper.

Yet *if* our goal is to *explain* why this or that business structure prevails, we would be wrong to ignore the national political and social environment surrounding the firm. Pierre Trudeau was once asked at the White House what it was like to lead Canada, a nation whose population is about one-tenth that of its big neighbor to the south. He replied, to paraphrase, that it was like sleeping next to an elephant. Even if the elephant is benevolent, and even if it is unaware of your existence, nevertheless small movements by the elephant at night deeply affect the quality of your sleep.

So it is with corporate ownership and governance. Two of the 'elephants' are the product and capital markets, and these two have long been properly seen as affecting firms' ownership and governance. But a big neighboring 'elephant' is also the firm's political environment, the degree to which the average voter wants government to affect the firm, how governments in fact affect firms, and the ways in which firms react to those political impulses. This 'elephant' is less often seen, and its effect hardly ever analyzed, but it can deeply affect the shape, structure, and governance institutions of the large business firm.

Figure P.1 shows an abstracted firm in its environment, with capital and labor markets affecting shareholder structure and managerial institutions, and with political institutions and product markets affecting the firm as well. Perhaps the picture shows the firm more beleaguered and confined than would be real: the firm shapes its environment too, and the way it reacts to pressures—defensively choosing this or that structure to ward off external threats or offensively seeking to mold a nation's politics—can affect corporate governance in important ways.

Among the rich democratic nations—the nations that could support large, public firms—some polities have encouraged the institutions that stabilize the large public firm with diffuse ownership. Some have not. These differences, arising

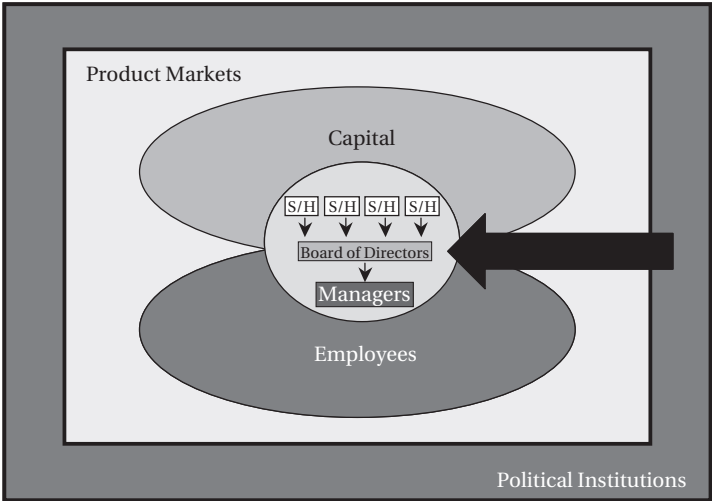


Fig. P.1. The corporate governance environment

from labor politics, orientation to shareholder value, and market conditions, can largely determine the ownership structure of large firms.

Consider nation-by-nation differences in how strongly governments support employee pressures on the firm. When employee pressures are weak—or when the government pays little attention to them—the firm has more options than when they are strong. Those kinds of employee pressures inside the American firm have been weak. Not so historically in most other Western nations, where employees have at times seized factories, where governments have sought to stabilize employment inside the firm by confining owners’ discretion, and where national politics has at times vividly focused on the division of the economic spoils in ways that are pallid in American politics.

Before a nation can produce, it must have sufficient economic peace that the factory can function. The ways in which nations achieved—and maintained—that peace were not all identical; and these differences shaped corporate governance, ownership, and power inside the firm.

This political determinant, under-examined but tugging on the firm as strongly as the moon determines the tides, is the one that I focus on in this book. I do not offer a theory of *all* political determinants, but a theory and data on this one powerful political determinant. Our examining it should, I believe, greatly advance our understanding of the large firm. This political determinant—strong stakeholder pressure, whose political manifestation I call here, for lack of a better term, social democracy—affects the firm directly and also induces a counter-pressure inside the firm, usually for more focused, concentrated ownership. Perhaps a better title for this book, were it not for euphony, would have been ‘A Political Determinant of Corporate Governance’.

One can look at this political dimension from differing angles. Each angle has the firm at its vertex, collecting capital-contributors, managers, and employees. One angle is of coalition-building: strong social democracies strengthen a managerial-employee coalition and weaken a capital-managerial coalition. Owners there would have even more reason than elsewhere to seek to weaken the first and strengthen the second. Another angle views the firm through the lens of basic agency cost literature, a literature that focuses on the flaws in managers' loyalty to shareholders interests. The political focus here is that politics affects the size of the managerial agency costs that shareholders bear. When politics raises these costs, shareholders would demand more in the way of compensating firm structures that would make managers less likely to stray from shareholder loyalty. This agency cost perspective is the one we shall use for the most part, not because it's the only one but because it allows us to paint the issues quickly with a few brush-strokes. The agency cost style of analysis is common, and the vocabulary is regularly used in many academic disciplines.

Another angle is the perspective of micro-economic competition. Fiercely competitive markets support (or are supported by) one package of ownership structures and political orientation (namely, diffuse ownership and relatively conservative economic politics). Or the angle of view might be that of labor: if a nation's labor markets are not fluid and employees 'own' their positions, that kind of a labor market calls forth countervailing ownership and governance structures of a kind differing from those prevailing in nations where labor markets are fluid and employees less protected by political institutions from the markets' ravages. Or, to take a last possible perspective, mechanically smooth corporate law is important for a nation in facilitating diffuse ownership and investor protection. But if the political environment is unfriendly to diffuse ownership, then even if the mechanical prerequisites, like a supportive corporate law, are in place, they will not be used if the political 'elephants' are restless and likely anyway to trample the small, diffuse shareholders.

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Introduction

Before a nation can produce, it must achieve social peace. Factories that fail to produce because of internal turmoil or external upheaval are less valuable than those that produce smoothly. If conflict is expected, investors invest reluctantly, or not at all, and the factory is not built. Or investors search for the organizational form that minimizes the chances and costs of conflict. Dampening turmoil, or insulating the firm from it, can be a strong force in shaping firms' ownership and governance. Perhaps secondary in the United States, these considerations have historically often been primary in other nations.

Social peace has been reached in different nations by differing means, some of which have then been embedded in business firms, in corporate ownership patterns, and in corporate governance structures. The ways to achieve and maintain social peace vary, and that variety explains quite a bit of why corporate governance structures vary around the world.

Politics can affect a firm in many ways: it can determine who owns it, how big it can grow, what it can produce profitably, how it raises capital, who has the capital to invest, how managers or employees see themselves and one another, and how authority is distributed inside the firm. For concreteness I focus on one key variable: the degree to which ownership separates from control. This is in itself a key aspect of the modern corporation, and emphasizing it gives us the discipline of dealing with a single variable, one for which finance theory is well developed and about which data can be had to test, probe, and better understand how the firm's political environment affects it. Ownership will be our primary focus, but it reflects the bigger claim, that much of the firm's structure is affected, sometimes determined, by its political environment, and if we fail to scrutinize the political impact on a firm, we are unlikely to get the full story.

The large publicly held, diffusely owned firm dominates business in the United States despite its infirmities, namely the frequently fragile relations between stockholders and managers. Managers' agendas can differ from shareholders'; and tying managers' actions tightly to shareholders' goals has been central to American corporate governance. But in other economically advanced nations ownership is not diffuse but concentrated. The problem to explain is why ownership of large

2 INTRODUCTION

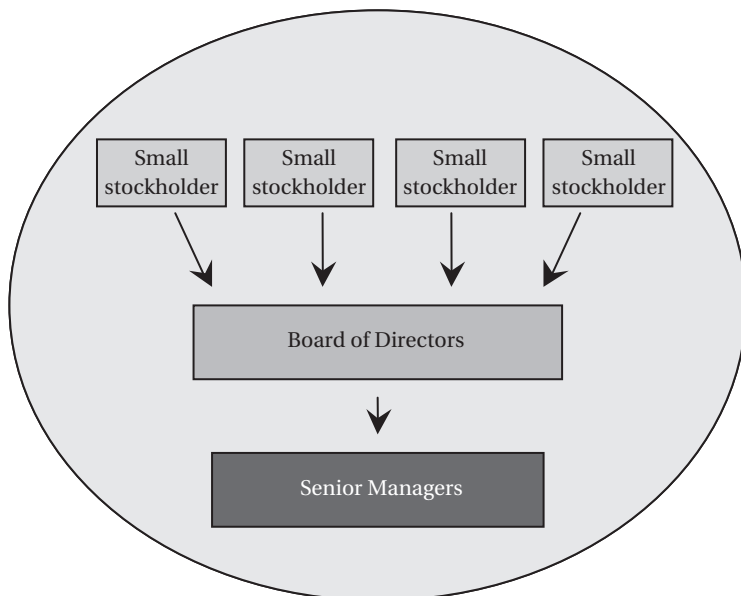


Fig. 1. Diffuse ownership

firms in the United States is diffuse, as depicted in Figure 1, while in so much of the rest of the wealthy West fewer firms go public at all, and of those that do, the firm's ownership is typically concentrated not diffuse, with a dominant stockholder as depicted in Figure 2. Although the American institutional investor has in recent years made the American stockholder less remote than it once was, even today ownership is much less concentrated in the United States than it is in the other nations in the wealthy West. It has been concentrated elsewhere in the wealthy West in no small measure because the delicate threads that tie managers to distant shareholders in the public firm fray easily in common political environments, such as those in the continental European social democracies.

Social democracies press managers to stabilize employment, to forgo some profit-maximizing but risky opportunities for the firm, and to use up capital in place rather than to downsize when markets no longer are aligned with the firm's production capabilities. Managers must have discretion in the diffusely-owned public firm, and how they use that discretion is crucial to stockholders, in that managers' actions produce the firm's profits. Social democratic pressures induce managers to stray further than otherwise from their shareholders' profit-maximizing goals: managers with discretion there are pushed away from being aligned with shareholders' typical profit-oriented goals. Moreover, the modern means that align managers with diffuse stockholders in the United States—incentive compensation, transparent accounting (whose recent failures highlight both its importance and its fragility), hostile takeovers, and strong shareholder-wealth maximization norms—have been weaker and sometimes denigrated by continental social democracies.

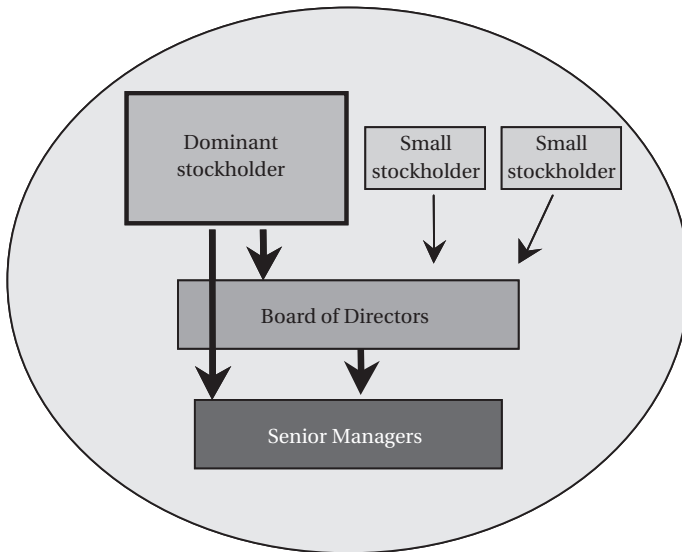


Fig. 2. Dominant stockholder in public firm

Hence, public firms there, all else equal, have had higher managerial agency costs, and large-block shareholding has persisted as shareholders' best remaining way to control those costs. Indeed, when we line up the world's richest nations on a left-right political continuum and then line them up on a close-to-diffuse ownership continuum, the two correlate powerfully.

True, the effects on total social welfare are ambiguous; social democracies may enhance total social welfare, but if they do, they do so with fewer public firms than less socially responsive nations. We thus uncover not only a political explanation for ownership concentration in Europe, but also a crucial political prerequisite to the rise of the public firm in the United States, namely the weakness of social democratic pressures on the American business firm.

* * *

That corporate governance structures around the world have differed is hardly contested. The very fact that many people talk today, at the beginning of the twenty-first century, about corporate convergence due to globalization tells us that people believe that corporate structures have sharply varied. The task here is to better explain why they varied. The thesis here is straightforward: prevailing explanations—based on the level of economic and technological development, on differing economic tasks, on random variation, and on the quality of technical corporate law—while important and not to be discarded, are incomplete. One big explanation is absent from the literature, namely that how social conflict has been settled powerfully affects how firms are owned and how authority is divided.

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Politics at times directly requires boardrooms and ownership structures to be a certain way. At other times it induces reactions, as, say, owners seek to mitigate political effects or employees react negatively to a political or economic result. At other times politics simply raises the costs of a particular structure, making that more costly structure less likely to arise and prosper.

No single explanation is going to dominate the others at all times: the level of economic wealth, the technological demands for large size, the institutions of capital-gathering, the prevailing tax rules, the legal institutions of the large firm are all important. My task here is hardly to refute the importance of these explanations for the rise of the large firm and the separation of ownership from control, but to focus on a deep, important, and missing political explanation.

I focus on two major corporate differences: the degree of separation of ownership from control, primarily and, secondarily, the degree of labor influence. The two are connected. In the United States ownership of the largest firms has been diffuse for quite some time; on the European continent, ownership has been concentrated, with even the largest firms privately-owned or, if their stock traded publicly, with a single owner controlling a big block of stock. In the United States, labor participates rarely in the core institutions of the firm's governance at the top, rarely owns significant stock directly, and even more rarely participates on the board. In France, a dynamic family and entrepreneurial sector challenged a government-dominated sector; public policy favored employees with jobs in place, and diffusely-owned firms were rare. In Germany labor still takes half of the seats of the supervisory board, in the most explicit manifestation of a political determinant of corporate governance. In Italy in the decades ending the twentieth century there were few public firms, social conflict in the largest firms spilled over into politics when the communist party in Italy was strong, and nominally conservative governments both denigrated the profit-oriented culture needed to make large firms' managers function well for shareholders and built up small businesses at the expense of large ones to deny fertile fields to the communist unions. In Japan, the firm was typically run at the top by a large board of insiders assured of lifetime employment. Banks have also been shareholders, and their loans induced them not to seek to maximize their wealth as shareholders. Some of these structures arose and prospered in Japan during times of intense social conflict. Similarly, the incidence of hostile takeovers, proxy fights, and incentive compensation mechanisms varies greatly around the world; sometimes used not at all, sometimes becoming central to corporate governance.

Those are nation-by-nation specifics. But we can generalize into a theory with predictions. Social democracies favor employees with jobs in place. They wedge open the gap between shareholders and managers by pressing managers to expand, to avoid downsizing, and to go slow in taking risks that would affect the work place. These are just the kinds of managerial agency costs that have been common at times in the large American firm: American managers when not strongly tied to shareholders' interests have *also* tended to expand, avoid, and go slow, despite the weaker political pressures here on managers to expand, avoid, and go slow. Moreover, social democracies denigrate the modern pro-shareholder tools—such

as incentive compensation, hostile takeovers, shareholder wealth maximization norms, etc.—because it is *not* their policy to promote purely shareholder values.

* * *

Non-political explanations abound for why some nations have concentrated ownership and some do not. Different levels of economic development, technology, culture, or tax and legal structures have all been invoked. Specific structures in one nation or another influence the ownership result: Germany's tax rules favored block ownership. Italy's weak courts made complex corporate legal structures hard to maintain. French statist institutions weakened securities markets. British pension funds facilitated diffuse ownership. Banks in Germany, and incumbents more generally, have tried to block securities market development.

Each local institutional structure surely explains some variation. And for some nations at some times a specific structure could explain much variation. But each local explanation is compatible with there *also* being a political explanation that runs across national boundaries. No *one* single explanation determines ownership and corporate governance.

And each local explanation fails to fully explain the ownership and governance results around the world, leading us to need more to explain the differences. For example, while many developing nations have weak securities markets, there are also several wealthy nations in the West whose securities markets are shallow. Differences in the quality of technical institutions surely explain some of the variation, especially when we compare the wealthy West with the developing East. But too many rich nations have very good institutional structures and strong institutions—corporate, legal, and otherwise—but *nevertheless* have concentrated ownership. Something else is at work promoting concentration and impeding diffusion, and to understand why securities markets and ownership separation do or do not develop, we need to find a better explanation.

We can do so, with a powerful political story, by relating a nation's macro-politics to the firm's micro-structure. Begin by abstracting the firm into three basic parts: ownership, management, and employment. Social conflict, often among owners, managers, and employees, leads to political settlements—indeed, for a nation to be one of the world's richest, social conflict must somehow have been kept from getting out of hand—and these settlements can determine the structure of one of these pieces of the firm.

By determining one of the three basic pieces, politics can thereby often determine the others as well, because the pieces fit together—like pieces of a jigsaw puzzle—as complements. That is, some politically required employment pieces fit well with only a few types of management pieces. Hence, politics could, say, determine a particular labor structure, which might call forth only one type of ownership or management structure. For example, German codetermination—by which labor takes half of the board seats—demands concentrated ownership, because shareholders would do poorly if they failed to meet the boardroom's labor block with their own block. Which came first is not important to the analysis. (And, since concentrated ownership came first, the political complementarity between labor

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voice and ownership concentration has not been seen clearly.) But once one institution is locked into place, the other is called forth, and *neither* can change easily without the other changing as well. Co-ordinating change of multiple institutions simultaneously is hard, and that is one major reason why many of the differing corporate structures around the world have thus far persisted, resisting full convergence despite the post-war convergence of living standards and productivity.

I proceed in this book by telling a few quick stories for national systems and then, in this book's mid-section, I generalize the inquiry. Social democracy fits badly with the diffusely owned public firm. Social democracies fray the ties between shareholders and managers, and ownership thereby seeks a better way to control management, with the best alternative in a social democracy being a concentrated ownership structure. The correlation between a nation's political orientation and its corporate ownership structure is powerful.

Other economic and political elements fit together as well. One can see two packages of industrial organization, democratic macro-politics and corporate ownership structure. One has weakly competitive markets fitting with social democratic politics and concentrated ownership. The other matches fiercely competitive markets, conservative almost *laissez-faire* politics, and diffuse ownership. Many of the social democracies have had weakly competitive product markets. Weak product markets weaken one important constraint on managerial agency costs, making diffuse ownership more costly for shareholders. This tends to induce more concentrated ownership, all else equal.

Moreover, contests over how to split the monopoly corporate profits can spill over into democratic politics in ways that are harder to politicize if competitive markets limit the firm to competitive profits: the cupboard is too easily bare, leaving less to contest. Globalization, for example, is said to press firms to do less for employees. Part of the globalization pressure we see around the world is due to the shrinking of local monopolies as product market competition intensifies. True, employees may do better overall when globalization improves their welfare as consumers even if it squeezes them as employees. But the corporate governance implication here is that globalization presses firms to match pay closely to productivity: managers have less discretion over wages than when they faced less competitive product markets. That shrinking of local monopolies weakens stakeholder pressures on the firm's managers—because there is less available over which managers have discretion to share—and as those internal pressures to share diminish, this source of the demand for concentrated ownership might diminish as well, opening the way for a nation to develop deeper and wider securities markets.

While we examine the rest of the developed world in this book's mid-section, the theory here is one about the United States as well. And that is where we shall conclude: there was a powerful political pre-condition to ownership separating from control in the United States, to the rise and persistent dominance of the American large public firm with diffuse ownership, and to the eventual disappearance of block and family ownership, namely *the absence in the U.S. of a strong social democracy*. Where social democracy was strong, the public firm was unstable, weak, and unable to dominate without difficulty; where social democracy was

weak, ownership diffusion of the large firm could, if other economic and institutional conditions prevailed, begin.

* * *

The argument here is not normative: it is *not* that strong social democracies do not deliver the goods in a utilitarian sense. There is tension between large diffusely-owned firms and strong social democratic polities, and, hence, one might, by showing this relationship, be taken to suggest that this strain of politics short-changes its citizens. But that is not the argument. Indeed, one might intuitively think the contrary: by providing *more* for a *wider* base of people, those governments may achieve a utilitarian goal of the greatest good for the greatest number more effectively than other polities.

But I do not evaluate this utilitarian possibility—that these arrangements could be more than just a second-best accommodation but a first-best result—one way or the other. Moreover, the argument I present suggests the possibility of *several* roads to utilitarian goals: peace is predicate to production. If substantial social peace is achieved in different ways in different nations, then the historical routes were several to achieve a modern economy.

* * *

Today's policy-makers have reasons to come to grips with these political reflections inside the large firm. International agencies seek to change corporate governance systems in developing and transition nations. But corporate governance is not just mechanical rules and basic institutional capacities (such as good corporate law, good courts, and so on). The corporation ties, sometimes tightly, to national politics, and plunking down modern (usually read as American) rules and business institutions would be unlikely to produce the reformers' desired results if the institutions badly match the politics. The mechanical rules and institutions could be the same, but if politics sharply differs, so might the corporate results.

True, reformers can change business practices and legal rules more easily than they can change a nation's deep political and social structure. So, if one approaches corporate governance from a law reform perspective, it usually is correct to analyse the business firm as it has conventionally been analysed, as an economic, financial, and technological organization: we, or the reform agencies, assume the political and social predicates of the society as given, and look at the 'marginal' institutions susceptible of immediate change. If one seeks to improve business results, it is best to focus first on what can be changed and not what, at least in the short run, will resist change. No need to examine political bedrock, if drilling through it in the short run is impossible.

Yet we cannot always avoid examining it: if the mechanical institutions just do not mesh with the underlying political foundations, fixing the mechanics will be harder than the reformers anticipate. And if our goal is to explain which institutions prevailed in the wealthy West, we cannot avoid looking at the firm's political environment.

* * *

8 INTRODUCTION

The task here lies across several disciplines, including law, political science, and economics. And the methodologies needed are several as well—the logical analysis of incentives and institutions from law and economics, the statistics and modeling (simple though they may be here) of financial economics, and the historical/political scrutiny of comparative politics. I do not purport to be sufficiently expert to catch every nuance in each field or method, but I hope that by combining them, we gain deeper insights.

* * *

A road map for this book: in Part I, I set out the general theory that peace must precede production and how the terms of peace can affect corporate governance. I also set out the core differences in corporate governance around the world.

In Part II, I set out the theory that social democracy and the diffusely owned firm are in tension. I link a nation's political orientation to the micro-structure of the firm, by showing how social democracies press managers to coalesce with employees, not with distant shareholders, and how the means that tie managers to shareholders in American public firms fray in strong social democracies. Owners must consequently seek other means to control managers, and the best alternative is close ownership or block ownership of the equity. Whether life is better for more people is hard to know, but public firms would be fewer and ownership separation narrower.

In Part III, I test the political hypothesis with a simple statistical inquiry: if we array nations on a left-to-right political scale, and then array them on a highly-concentrated to highly diffuse ownership scale, the two scales correlate powerfully. The political explanation, in statistical terms, does as well, or better, at explaining variation in ownership concentration in the world's richest nations as do competing theories, such as a currently-popular one based on the strength of technical corporate law.

In Part IV, I narrate relationships between social politics and corporate governance in seven of the world's richer nations. France has a long history of statist economic policy. Before the First World War, when the overall tenor of its statism was *conservative*, securities markets were developing strongly; in modern times its leftward bent precluded sharp ownership separation. German codetermination is the clearest institutional manifestation of the social democratic thesis. Labor takes half of the board seats in large firms, inducing shareholders to be better off with a counter-coalition. Italy for a quarter of a century had a communist party on the verge of political power; ownership concentration helped to make deals stick inside the big firms and facilitated a counter-coalition inside the firm and inside the polity. Japanese lifetime employment is another way to achieve social peace. Japanese firms' insider-dominated boards and their history of strong bank-creditor influence—both being risk-avoiding players—fit with lifetime employment. Sweden also exemplifies the thesis: the world's first social democracy, it had strong minority stock issuance, but very little ownership separation. The United Kingdom's securities markets first developed during its first strong *laissez-faire* period and seemed to stagnate mid-century when its

political economy changed. And the United States has had one of the world's weakest social democratic influences and one of its strongest securities markets, with much ownership separation.

In Part V, I deepen the inquiry by examining the direction of causality. In the first four Parts I take politics as given and examine its consequences for the firm. In Part V, I inquire into how corporate and economic structures can induce political backlash. Not all efficient structures are politically stable. Some structures induce political backlash, inducing corporate structures to bend to survive, or to crack and fail. I offer some generalized instances of each and show some corporate governance implications. I also in Part V link the political story to product markets: there are complementary fits of ownership structure, politics, and industrial organization. One can in theory take the same agency cost-driven political story of Part I and, by beginning with the severity of market-place product competition, derive the same corporate governance (and, surprisingly, political) results. Separation fits with conservative democratic politics and fierce product market competition. Some of the social tensions around the world today are due to one piece of the package changing quickly without the others yet changing as quickly.

In Part VI, I discuss the fit between the political theory and a leading academic theory, that the quality of technical corporate law determines whether securities markets will arise, whether ownership will separate from control, and whether the modern corporation will prosper. The theory has been used convincingly to explain why we see weak corporate structures in transition and developing nations, less convincingly to explain why concentrated ownership persists in continental Europe, and probably incorrectly to explain why ownership separated from control in the United States. Surely, when an economically weak society lacks regularity—a gap that may be manifested by weak or poorly enforced corporate law—that lack of regularity and economic strength precludes complex institutions like securities markets and diffusely owned public firms. But the converse is not true: when we see ownership concentration we cannot be sure whether distant stockholders fear the rapacity of insiders—who could, if corporate law is weak, divert value to themselves—or the disloyalty of managers, who might fail to get good shareholder profits. Corporate law deals with rapacity and self-dealing, *not* with managerial mistake. But the latter can impede diffuse ownership as easily as the first, and via America's elaborate business judgment rule the latter *is immune from corporate law inquiry*. Indeed, even in nations with good legal structures generally and, by measurement, good shareholder protection—such as in Germany and Scandinavia—ownership *did not* separate from control. Something more than just weak corporate law impeded securities markets from flourishing in such nations. The political theory I offer here tells us what that something else was.

The analysis in Part VI is quite relevant to today's policy-making corporate bodies, such as the international agencies that are promoting corporate governance institutions in Third World and transition nations that would mimic American institutions. Their goals are worthy, but even if they succeed in building the mechanical institutions they are after, the corporate structures might persist if the nations' underlying politics is not conducive to the policy-makers' goals.

10 INTRODUCTION

In Part VII I unify two political theories: a democratic polity does not easily accept powerful pro-shareholder institutions. In the United States, this unease once manifested itself in a populism that historically kept financial institutions small, denied them strong stock-based portfolios, and took away their authority to act directly inside the firm. In more modern times, this popular force manifested itself in laws that dampened hostile takeovers in many states, without eliminating them. By taming the strongest shareholder institutions such as concentrated financial power, the American polity more willingly, albeit perhaps grudgingly, accepted other pro-shareholder institutions. In Europe, this political force sought to tame capital directly, by constricting its range of motion in the firm: employees with jobs got both protection from being laid off and voice inside the firm, pro-shareholder institutions were denigrated, and owners reacted to maximize their value in that kind of polity. If one fails to understand these political impulses, one cannot fully understand the world's, or any single nation's, corporate governance institutions.