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ECGI Working Paper Series in Law

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Abstract

Over the last 25 years the term "corporate governance" has entered the lexicon of economists and other students of business. This development has been accompanied by growing interest in differences in institutional structures – like corporate governance systems – across countries. Among the many questions regarding the effects of corporate governance systems that have been examined, one of the most important has been to measure the effects of corporate governance systems on corporate performance somehow measured, or more broadly the economic performance of countries. This paper reviews some of this evidence and takes up the questions of which system is «best,» and whether this superiority is likely to lead to a convergence of corporate governance structures over time. With a few exceptions, most studies of the effects of corporate governance institutions treat them as exogenous. This paper also discusses the historical and political determinants of corporate governance institutions.

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The Economics and Politics of Corporate Governance in the European Union

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I. Introduction

Over the last 25 years the term "corporate governance" has entered the lexicon of economists and other students of business. This development has been accompanied by growing interest in differences in institutional structures – like corporate governance systems – across countries. A generation ago theoretical models of the firm (often implicitly) would have assumed an "Anglo-Saxon" institutional environment, and empirical tests of various hypotheses would be made using data from the United States, or perhaps other Anglo-Saxon countries like the United Kingdom or Canada. Today economics and finance journals are filled with empirical investigations of corporate behavior and performance in countries with non-Anglo-Saxon institutions with Continental Europe, Asia, and the transition countries being popular choices for data samples. Although the literature is still dominated by researchers from Anglo-Saxon countries, their research is no longer confined to analyses of companies in these countries.

Among the many questions regarding the effects of corporate governance systems that have been examined, one of the most important has been to measure the effects of corporate governance systems on corporate performance somehow measured, or more broadly the economic performance of countries. As recently as a decade ago, some scholars saw "insider corporate governance" systems in which banks play an important role monitoring managers and allocating capital as superior to the "outsider systems" of the Anglo-Saxon countries.[1] More recent research has tended to claim superiority for Anglo-Saxon institutions.[2] Some

evidence regarding this question is summarized and discussed in the next section. We take

up the questions of which system is "best," and whether this superiority is likely to lead to a

convergence of corporate governance structures over time in the final two sections of the

paper.

Most studies of the effects of corporate governance institutions treat them as

exogenous variables. Germany and France have insider-systems with large fractions of a

company's shares or votes controlled by a single family or institution. The United States and

United Kingdom have widely dispersed share distributions. A few studies have questioned

why this is so, which is to say have treated corporate governance institutions as *endogenous*

variables. The historical and political determinants of corporate governance institutions are

discussed in Section III. Knowledge of the determinants of corporate governance institutions

is, of course, essential when making predictions about whether corporate governance systems

can change or are likely to converge.

II. Corporate Governance and Economic Performance

A. The Effects of Legal Systems

The assumption that corporate governance institutions have important effects on

corporate and economic performance rests on the assumption that there are potential

principal-agent problems between managers and owners of a firm. A company's

performance as judged by its shareholders suffers, if managers can use their positions to

advance their interests instead of those of the shareholders. The most blatant examples of

such conflicts of interest involve managers diverting the resources of the firm into their own

pockets − as occurred at Enron. Less conspicuous conflicts can arise, however, over dividend

and investment policies. Starting with Robin Marris (1964) a large literature has posited that

managers are "empire builders" who pursue growth in excess of the levels, which would

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maximize shareholder wealth.[3]

The pursuit of excessive growth by managers produces a conflict between them and their shareholders over dividend and investment policies. Growth-maximizing managers invest too much and pay out too little dividends from the perspective of the shareholders. Here it is important to keep in mind that investment might not solely take the form of purchases of plant and equipment in a company's major line of economic activity, but may also consist of unprofitable diversification and wealth-destroying mergers.

The conflict between managers and shareholders over dividends and investment underlies LLSV's (2000) test of the importance of legal institutions in aligning shareholders' and managers' interests. They argue that Anglo-Saxon legal institutions are better at aligning shareholders' and managers' interests than civil law systems, and within the latter category that Scandinavian legal systems are better than Germanic-origin systems, with French-origin systems offering shareholders the least amount of protection. Column 3 of Table 1 reports the dividend payout ratios for large listed companies in a set of countries arranged in accordance with the LLSV legal system categorization. I have limited the set of countries to Europe and the highly developed Anglo-Saxon countries outside of Europe (Australia, Canada, New Zealand and the United States) to eliminate differences in stages of development that might affect cross-national comparisons. The mean dividend-to-sales payout ratios conform to the predictions of LLSV insofar as the mean ratio for the Anglo-Saxon countries substantially exceeds that for each of the three civil law groups. Within the civil law countries, however, the four Scandinavian countries have the lowest mean payout ratio, where LLSV would predict that they should have the highest ratio.

Table 1

Differences across Countries in Legal Systems and Various Economic Statistics

Country	No. of firms	Dividend pay-out (% sales)	qm=r/i	Returns on equity	External Capital/GDP	Domestic firms/pop.	IPOs/ pop.	GDP growth
Anglo-Saxon								
Australia	346	0.048	0.94	0.082	0.49	63.55		3.06
Canada	1,478	0.027	1.16	0.097	0.39	40.86	4.93	3.36
Great Britain	1,331	0.035	0.85	0.129	1.00	35.68	2.01	2.27
Ireland	63	0.017	1.10	0.138	0.27	20.00	0.75	4.25
New Zealand	66	0.040	0.86	0.059	0.28	69.00	0.66	1.67
United States	8,591	0.026	1.05	0.118	0.58	30.11	3.11	2.74
Mean		**0.032**	**0.99**	**0.104**	**0.50**	**43.20**	**2.29**	**2.89**
Scandinavian								
Denmark	101	0.014	0.65	0.138	0.21	50.40	1.80	2.09
Finland	79	0.015	0.96	0.088	0.25	13.00	0.60	2.40
Norway	103	0.018	1.04	0.123	0.22	33.00	4.50	3.43
Sweden	156	0.019	0.65	0.152	0.51	12.66	1.66	1.79
Mean		**0.017**	**0.78**	**0.125**	**0.30**	**27.26**	**2.14**	**2.42**
Germanic								
Austria	82	0.031	0.71	0.105	0.06	13.87	0.25	2.74
Germany	425	0.015	0.57	0.117	0.13	5.14	0.08	2.60
Switzerland	160	0.022	0.64	0.136	0.62	33.85		1.18
Mean		**0.023**	**0.64**	**0.119**	**0.27**	**17.62**	**0.16**	**2.17**
French								
Belgium	79	0.026	0.51	0.144	0.17	15.50	0.30	2.46
France	495	0.020	0.57	0.116	0.23	8.05	0.17	2.54
Italy	150	0.014	0.64	0.067	0.08	3.91	0.31	2.82
Luxembourg	12	0.010	0.70					
Netherlands	174	0.034	0.69	0.155	0.52	21.13	0.66	2.55
Portugal	49	0.010	0.46	0.231	0.08	19.50	0.50	3.52
Spain	117	0.035	0.54	0.098	0.17	9.71	0.07	3.27
Mean		**0.021**	**0.59**	**0.135**	**0.21**	**12.97**	**0.34**	**2.86**

If all companies have the say levels of investment opportunities relative to their cash flows, all will have the same optimal retention ratio for maximizing shareholder wealth, and all will have the same optimal dividend payout ratio. Lower dividend payout ratios will imply overinvestment and more significant agency problems. When investment opportunities differ across firms, however, so too will optimal retention and dividend ratios. For a company with very attractive investment opportunities, the optimal dividend payout for the shareholders may be zero. Indeed, for firms with very attractive investment opportunities, no conflict between managers and shareholders over investment and growth may exist. Both wish to see the firm raise as much capital and grow as fast as possible (Mueller, 1972). Thus, a better test for the presence of agency problems would be to compare companies' returns on investment to their costs of capital. For companies, which maximize shareholder wealth, returns on investment should equal their costs of capital. Firms with growth-maximizing managers will have returns on investment that are less than their costs of capital.

Column 4 of Table 1 reports estimates of the ratios of returns on investment to costs of capital for large companies listed on the stock exchanges of each country. (The number of firms in each country sample is presented in column 2.) These figures constitute estimates of a *marginal* Tobin's q, and are thus designated as q_m .[4] The means of each set of estimates are in *exact* accordance with the LLSV predictions based on the country legal system categorization. Four of the six estimates are either insignificantly different from 1.0, or significantly greater than 1.0 (Australia, Canada, Ireland, and the United States), with the mean q_m for the Anglo-Saxon countries being just under 1.0. In contrast the mean q_m for *none* of the other three country groups comes close to 1.0, with the relative sizes of the means conforming exactly to the predictions of LLSV (Scandinavian $q_m = 0.78 >$ Germanic-origin $q_m = 0.64 >$ French-origin $q_m = 0.59$). *No* country with either a Germanic- or French-origin legal system had an estimated q_m equal to or greater than 1.0.

For testing for the existence of agency problems, marginal q is superior to both Tobin's q, which is often used as a measure of company investment performance, and dividend payout ratios. We have already commented on the difficulty with the later, and this problem is nicely illustrated by the figure for Ireland. Ireland had the lowest dividend payout ratio of any Anglo-Saxon country (0.017), a figure that is also less than the mean values for both the German- and French-origin countries. Yet, the estimate of q_m for Ireland is above 1.0 indicating an absence of agency problems regarding investment for the average Irish firm. Apparently Irish firms had very attractive investment opportunities – as suggested by the very large mean growth rate of the economy reported in column 9 – and thus low dividend payouts where consistent with optimal dividend payout policies.

Tobin's q is a measure of a firm's *average* investment performance and equals the ratio of the returns on its total capital stock to its cost of capital. A company like Microsoft could have a very large Tobin's q because of large infra-marginal monopoly rents, and yet be wasting its shareholders' money through bad investments like mergers. To test for the presence of agency problems with respect to investment policies, it is the ratio of returns on investment to cost of capital that is relevant, and these ratios suggest significant agency problems in non-Anglo-Saxon countries with the severest problems being in the countries with Germanic- and French-origin legal systems.

After presenting estimates of marginal q like those in Table 1, I am often asked how it would be possible that firms in countries like Belgium and France can survive. Will shareholders not abandon them, and thus they will not be able to raise capital to finance investment? Here it is important to emphasize the difference between returns on the investments companies make, and returns on their shares. Once the market recognizes the existence and size of an agency problem, the share price of a company adjusts to reflect the magnitude of this problem and shareholders can expect to earn the same returns on this

company's shares as on one whose managers maximize shareholder wealth. Abnormal

returns on shares are a result of unexpected changes in company policies not of the policies

themselves. This point is confirmed in column 5, where estimates of returns on common

equities in each country are reported. The highest returns on equity were earned by

shareholders in the French-origin countries, the lowest returns were earned in the Anglo-

Saxon countries.

In countries with weak protections for minority shareholders, both the demand and

supply of new shares will be lower. Individuals will be reluctant to purchase shares for fear

of being exploited by the managers, founding owner-managers will be reluctant to issue

shares because they will not be able to sell them at an attractive price. In countries with weak

minority shareholder protection, the market for shares suffers from a form of the lemons'

problem and can be expected to be very thin.[5] These predictions are by and large confirmed

in columns 6-8 of Table 1, where 3 measures of the size of external capital markets are

presented – the value of all equities listed on a country's stock exchange divided by GDP, the

number of domestic firms divided by population, and the number of IPOs divided by

population. All three measures are highest for the Anglo-Saxon countries and lowest for

either the French-origin (first two), or German-origin countries (third). Additional evidence

linking the size of external capital markets to the strength of corporate governance

institutions has been presented by Modigliani and Perotti (1997) and Demirgüç-Kunt and

Maksimovic (1998).

Levine and Zervos (1998) have presented evidence linking the size of a country's

external capital market to its rate of economic growth, and Rajan and Zingales (1998)

establish a link between investment rates and external capital market size. Thus, one can

posit a causal chain running from the strength of corporate governance institutions to the size

of external capital markets to economic growth. The last column of Table 1 presents average

growth rates for the various countries. A clear link between corporate governance institutions and economic growth is not apparent as the average of the growth rates for the six French-origin countries is about the same as for the Anglo-Saxon countries. The average for the French-origin countries is clearly pulled up by the strong growth-performance of Portugal and Spain, which started the period with much lower average incomes than the other countries and were thus able to benefit from the "catch-up" effect, as did Ireland in the Anglo-Saxon country sample. Macroeconomic growth rates depend on more than just the strength of corporate governance institutions.[6]

B. The Effects of Ownership Identities

The early literature dealing with managerial discretion and principal-agent problems assumed that an owner-manager would maximize profits, and thus deviations from profit maximization would arise only in the presence of a separation of ownership and control. The assumption that owner-managers are profit maximizers is questionable, however. An owner-manager may also get psychological rewards from commanding a large empire. Indeed, writing almost a century ago, Joseph Schumpeter characterized entrepreneurs as empire builders rather than profit maximizers.[7] The likelihood that an owner-manager pursues goals other than profits maximization becomes even greater when she is not the sole owner of the firm, but rather owns a controlling stake in it (see following subsection). Thus, one cannot unequivocally predict that a firm controlled by an individual or family will perform better than one with dispersed ownership.

When a dominant shareholder exists in the United States, it is usually a person or family. In other countries, dominant shareholders are often institutions, however – other firms, financial institutions (banks, insurance companies), or the state. As when individuals own controlling stakes, it is not possible to make clear predictions about the effects of these

institutional shareholders on the performance of companies. For example, it was once commonly believed that German banks improved the performance of German companies by performing the monitoring role that shareholders in Anglo-Saxon countries fail to carry out (Cable, 1985). Through their direct ownership of shares and their authority to vote those shares that are deposited with them, however, German banks essentially control themselves and their managers are free to pursue their personal goals (Edwards and Fischer, 1994). Why should bank managers not be empire builders? If they are, they are likely to encourage the companies that they control to pursue growth, for this will allow the banks to expand their loans and consulting services.[8] Similar ambiguities exist for the other two institutional ownership categories.[9] As so often happens determining the effects of ownership identity on company performance turns out to be largely an empirical issue.

Table 2 presents estimates of marginal qs for companies divided into five ownership categories and the four legal-system country groups. The estimates for the Scandinavian and Germanic groups are for the same seven countries that appear in Table 1. The other two groups include developing countries with Anglo-Saxon- or French-origin legal systems. A company is classified as controlled by X, if X is the largest shareholder in the company and holds at least 10 percent of its outstanding shares. When no person or institution owns at least 10 percent of the outstanding shares, a company is placed into the dispersed ownership category. What stands out in the table is the importance of legal system origin relative to the identity of the control category. All five q_ms for the Anglo-Saxon countries are greater than 1.0, only three of the remaining 15 q_ms in the table are greater than 1.0.

Table 2
Estimates of Marginal *q* for Various Control Categories and Country Groups

Control Category	Country Group			
	Anglo-Saxon	Scandinavian	Germanic	French
Family	1.08	0.77	0.60	0.57
Non-Financial Company	1.06	0.72	0.63	0.57
Financial Corporation	1.00	0.56	0.56	0.69
State	1.01	0.80	0.37	0.95
Dispersed	1.00	1.15	0.36	0.54

Source: Gugler, Mueller, Yurtoglu (2004c).

Two of the three q_ms that are greater than 1.0 are for firms with dispersed ownership in the Scandinavian and Germanic countries. These can be explained in the following way. We expect and observe very few firms with dispersed ownership structures in countries with weak corporate governance systems. When we do observe such a firm in these countries, one of two explanations is possible. Either the firm had such attractive investment opportunities that many individuals were enticed to purchase its shares despite the lack of protection afforded by the corporate governance institutions, or the managers were somehow able to bond themselves not to exploit minority shareholders, as for example by also listing their shares on the New York or London stock exchanges.

The lowest estimate of q_m in the table is for state-controlled firms in the three Germanic countries ($q_m = 0.37$). Agency problems appear to be particularly acute for these companies. On the other hand, the q_m for state-controlled firms in the French-origin countries

is larger than for any other ownership category and insignificantly different from 1.0. This might be because the state in French-origin countries is a good monitor of the firms it controls, or because state-controlled companies in these counties are largely located in markets with limited competition and attractive investment opportunities.

The last observation to be made about Table 2 is that it provides little evidence of any positive effects from control by financial institutions. Only within the French-origin group was the q_m for financial-controlled firms significantly larger than for all other ownership categories, but this was not because financial-controlled firms performed so well ($q_m = 0.69$), but rather because all other firms in the French-origin countries performed so poorly ($q_m = 0.58$).

C. The Effects of Managerial Entrenchment and Financial Incentives

Morck, Shleifer and Vishny (1988, hereafter MSV) were the first to explore the relationship between firm performance and the fraction of shares held by managers using data for large US corporations. They estimated an equation of the following form

$$q_a = \text{aIS}_5 + \text{bIS}_{25} + \text{cIS}_{25+} \tag{1}$$

where q_a is Tobin's q or *average q* as explained above, and IS_5, IS_{25} and IS_{25+} are the fractions of shares held by managers (insiders) over the ranges 0 to 5 percent, 5 to 25, and greater than 25. Their estimated coefficients exhibited the following pattern of signs, a > 0, b < 0, and c > 0. Tobin's q rose as insider ownership increased over the range 0 to 5 percent reaching a value of roughly 1.0 at a 5 percent ownership stake. Tobin's q than fell as insider ownership increased over the range 5 to 25 percent reaching roughly 0.7 at a value of 25 percent. From then on it rose. MSV attributed this zig-zag pattern of coefficients to two conflicting incentive effects of insider ownership – an entrenchment and a wealth effect. As insiders' shareholdings in their firm increase they become more entrenched as it is more difficult to

remove them by launching a proxy contest or a hostile takeover. On the other hand, the larger their financial stake in their firm, the more insiders will identify with shareholders. These two conflicting effects were assumed to be of different strengths over different ownership ranges.

Several studies have reported the same up/down/up again relationship between performance and ownership concentration (Cho, 1988; Short and Keasey, 1999; Cosh, Guest and Hughes, 2000; and GMY, 2004b). McConnell and Servaes (1990, 1995) observed only the first part of the curve – an inverted parabola – in their US data, as did Thomsen and Pedersen (2000) for European corporations.

In a recent paper, GMY (2004d) eliminate the awkward non-linear relationship between firm performance and ownership concentration by using two variables to capture the two effects of ownership concentration. They argue that the wealth effect of insider ownership is captured better by the value of the insiders' stake in the firm. A manager owning $10 million dollars of her company's shares has the same financial incentive to increase their value regardless of whether this stake amounts to 2 percent or 20 percent of the firm's outstanding shares. GMY estimated the following equation

$$q = aIS + bVS + cVS^2 \tag{2}$$

where *IS* is again the fraction of shares held by insiders and is assumed now to capture only the negative entrenchment effect of insider ownership, and *VS* is the total value of their shareholdings. As measures of firm performance GMY used both average and marginal q. For a sample of over 3500 US companies they estimated coefficients with the following pattern of signs, a > 0, b > 0, and c < 0. Both measures of q fall as insider ownership increases due to the entrenchment effect, and rise with increases in the value of the insiders' ownership stake, although at a diminishing rate.

GMY included firm size and a few other variables in the estimated equation, since

firm size, and *IS* and *VS* are partially related to one another, one needs to take these
relationships into account when determining the ultimate relationship between insider
ownership and firm performance as measured by both average and marginal q. This ultimate
relationship is depicted in Figure 1. An inverted U or parabola is observed for both measures
of performance. At low levels of ownership concentration, the wealth effect of insider
ownership dominates. At a level of ownership between 40 and 50 percent, however, the
entrenchment effect begins to dominate. As economic theory predicts, marginal returns on
capital as measured by q_m tend to lie below average returns.

Figure 1
**The Relationship between *IS* and *qa*, and *IS* and *qm* in the US**
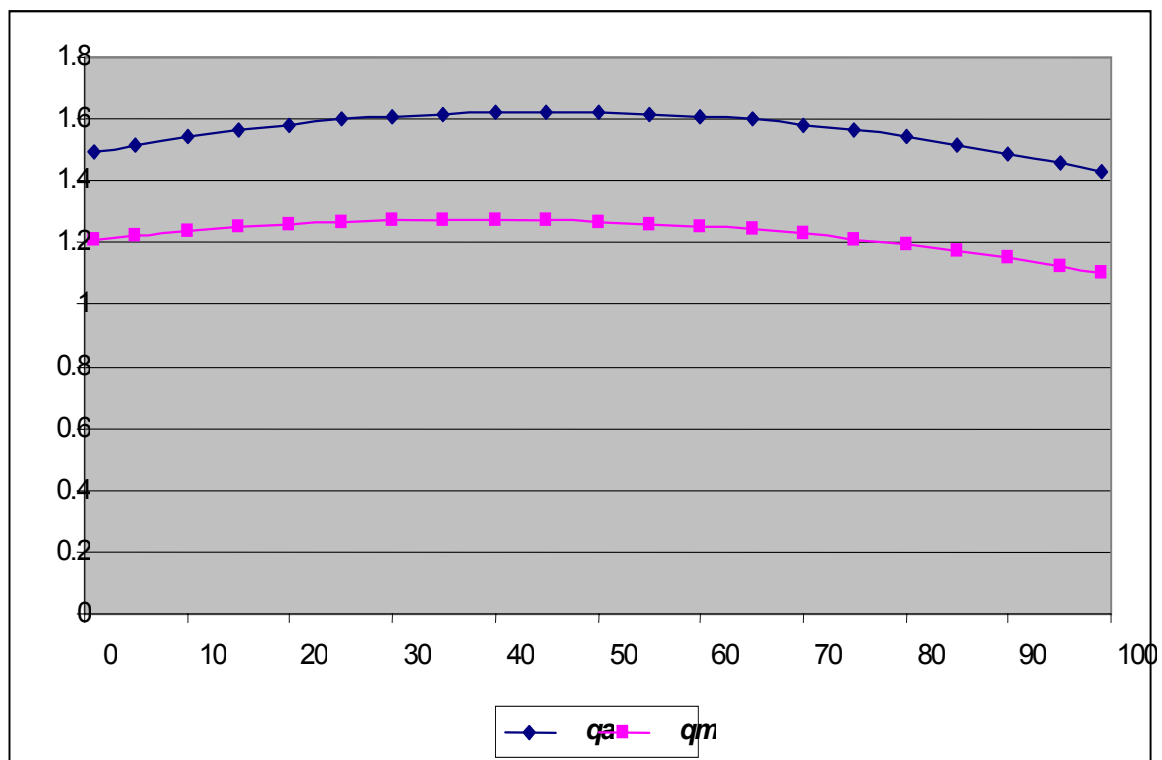
Figure 2
The Relationship between *LS* and *qa*, and *LS* and *qm* in the English-origin non-US sample
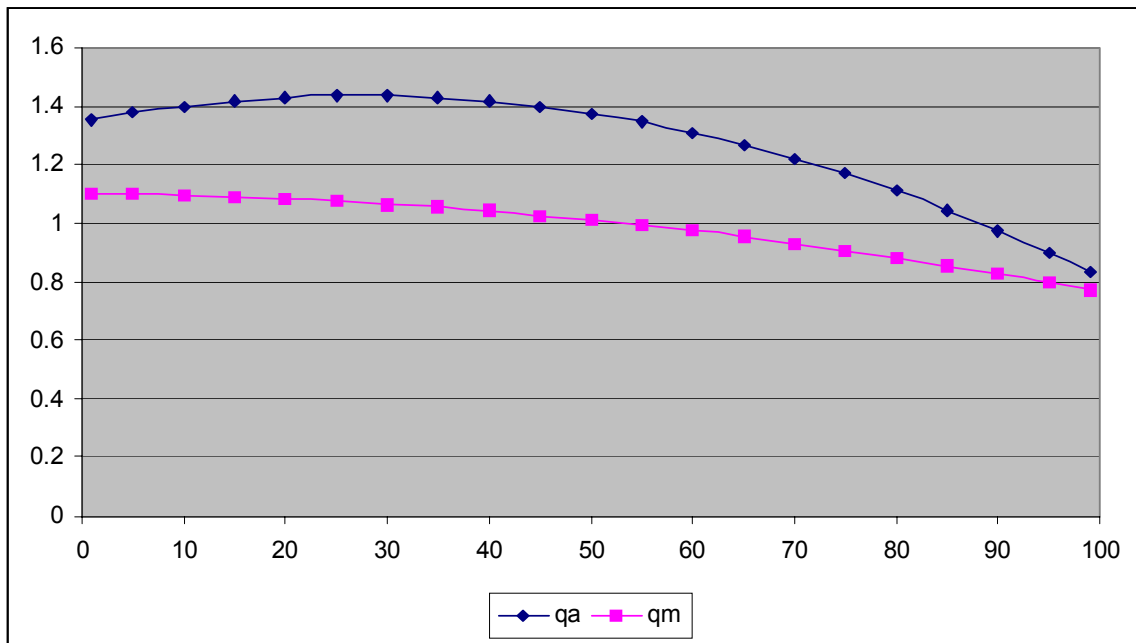
The same exercise was repeated for samples of companies from Anglo-Saxon countries other than the US, and for European, non-Anglo-Saxon countries. In both cases the same pattern of signs was observed on the key *IS* and *VS* variables. For the Continental European countries the wealth effect of insider ownership was much weaker than for the United States, however. Figures 2 and 3 depict the relationships between the two *q*s and *IS* for the other two samples of companies. For the Anglo-Saxon countries, the two curves start at essentially the same point. The relationship between q_a and *IS* is quadratic as for the United States, but the q_a curve rises only slightly and peaks much earlier than for the US – at around an *IS* of 30 percent. The relationship between q_m and *IS* is dominated by the entrenchment effect throughout with q_m falling below 1.0 at an *IS* of around 25 percent.

Figure 3
The Relationship between *LS* and *qa*, and *LS* and *qm* in the European Civil Law sample
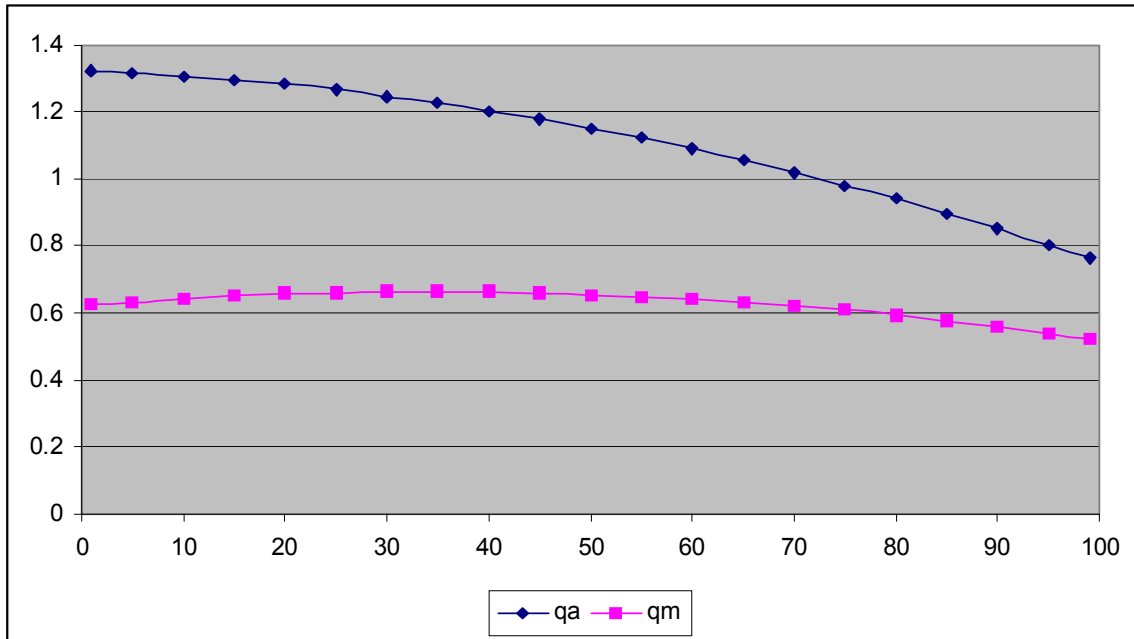
Source: Gugler, Mueller, Yurtoglu (2004d).

The q_a-curve for the civil law countries slopes continuously downward dropping below 1.0 at an *IS* slightly above 70 percent. The q_m-curve begins significantly below 1.0, rises a bit and then gradually declines toward 0.5 as insider ownership increases. A comparison of the heights of the curves in the three figures again reveals the superior investment performance of firms in Anglo-Saxon countries relative to Continental European countries. In the latter, the negative entrenchment effects of insider shareholdings and firm size tend to dominant the positive wealth effects of ownership over the entire range of *IS* values.[10]

III. Institutional Explanations for Differences in Performance

A. Legal History

LLSV (1997, 1998) identify significant differences across legal systems in the protection they afford outside shareholders from exploitation by insiders, and minority shareholders from exploitation majority shareholders. By better aligning the interests of all major actors in a firm, Anglo-Saxon and to some extent Scandinavian legal institutions produce better corporate performance as is evidenced in Tables 1 and 2 and Figures 1-3.

Paul Mahoney (2001) has offered a different explanation for why differences in legal institutions affect economic performance from that of LLSV. Mahoney argues that it is not the protection common law systems afford to *stockholders* that explains their superior economic performance in terms of things like growth, but rather the protection they offer to the *citizens* of these countries. By providing stronger protection of property rights, common law systems protect citizens from the arbitrary expropriations of property that can and do occur in civil law systems. This protection provides greater incentives to start businesses, enter into contracts, make investments and the like, and thus lead, according to Mahoney, to greater growth. This argument is somewhat related to that presented next.

B. Political History

Mark Roe (2000, 2003) also offers an alternative explanation for the differences in ownership and capital market structures between Europe and the United States to that of LLSV. Roe questions the legal institutions explanation, on the grounds that Europe's laws in other relevant areas like contract law are every bit as good as America's (Roe, 2000, p. 590). Moreover, constructing the institutions that would support large equity markets and protect minority shareholders is not "rocket science," and thus one expects that countries like

Germany and France would take this step to achieve the economic advantages claimed for the

Anglo-Saxon model of corporate governance (Roe, 2000, p. 602). The reason that they do

not, according to Roe, lies in their politics and not in their legal systems.

> In social democracies – nations committed to private property but
> whose governments play a large role in the economy, emphasize distributional
> considerations, and favor employees over capital-owners when the two
> conflict – public policy emphasizes managers' natural agenda and demeans
> shareholders' agenda. The pressure on the firm for low-risk expansion is high,
> the pressure to avoid risky organizational change is substantial, and the tools
> that would induce managers to work in favor of invested capital – such as high
> incentive compensation, hostile takeovers, transparent accounting, and
> acculturation to shareholder-wealth maximization norms – are weak ...
>
> Hence, managerial agency costs have been higher in social democracies than
> elsewhere, and we have ... a deeper, richer political explanation not only for the
> persistence of family ownership in France, Germany, Italy and Scandinavia, but also
> for the rise of the public firm in the United States. Social democracies do not strongly
> control public firm agency costs because they do *not* want unbridled shareholder-
> wealth maximization, and, hence, by weakening shareholder-wealth maximization
> institutions, they widen the gap between managers and dispersed shareholders. When
> the gap is wide enough, the large American-style public firm is rendered unstable
> (Roe, 2000, p. 543, footnote omitted, italics in original).

Thus, people who might become small shareholders, if they were afforded better

protection from managerial agency costs, in social democracies opt for fixed income forms of

investments over common equity. Those people who do own common equity in social

democracies prefer large blocks, which offer them some protection against managers'

opportunistic behavior.

Thus, Roe's political determinants theory of corporate governance provides an

explanation for both the difference in ownership structure between the United States and

Europe, and the difference in corporate performance. Large public companies in social

democracies are essentially forced to behave like growth-maximizing firms. They invest too

much and pay out too little dividends in part, perhaps, because such policies are to the

advantage of the managers, but also because they are to the advantage of the workers in a

firm who seek job security, and to the advantage of politicians who seek happy worker-

voters. Given the institutional and political bias in favor of workers over shareholders, the queue of people wishing to become shareholders is much shorter than in the United States.

Roe (2003) presents considerable evidence in support of his thesis in terms of both regression results and detailed political histories of individual countries. The thesis does not, however, fully account for the differences in investment performance presented in Table 1. It is not simply the United States, which has a superior investment performance to the Continental European countries, *all six* Anglo-Saxon countries have higher q_ms than does anyone of the ten countries with Germanic- or French-origin legal systems. The only two countries listed in Table 1 whose investment performance matches that of the six Anglo-Saxon countries are Finland and Norway, members of the highest ranked corporate governance systems by LLSV among the civil law countries. Here too it is perhaps worth pointing out that the differences in investment performance are not simply between "old Europe" and "young new world." Within Europe the four highest q_ms are for countries in the Anglo-Saxon and Scandinavian categories, while the seven lowest q_ms are for countries in the Germanic- or French groups. Moreover, the superiority in investment performance between Anglo-Saxon- and French-origin countries holds up, once developing countries are added to the sample, as is evidenced in Table 2.

Thus, something needs to be added to Roe's political explanation for the differences between the United States and Continental Europe in terms of corporate governance institutions and corporate performance to extend the argument to other countries. Canada and the United Kingdom, for example, look very much like the social democracies of Continental Europe when one examines the size of their public sectors (roughly 50% of GDP), their health care systems, and other indexes of social democracy. Yet the performance of the corporate sectors is much different from that of the Continental European countries. Why the difference? What is it in the heritage of Anglo-Saxon countries, which makes them

less receptive to the adoption of social democratic institutions governing business than other countries. As an economist, one would like to believe that a knowledge of the English language makes it more likely that one has read, *and understood,* the message of Adam Smith, whereas individuals with other mother tongues are more likely to have been exposed to the writings of Marx and other socialist writers from Continental Europe. But as an *institutional* economist, one seeks an explanation that is more directly linked to institutional differences across countries. An attempt at such an explanation is offered in the next subsection.

C. Political Institutions[11]

Money buys votes. It does so in two senses. (1) The more money a candidate spends in an election campaign, the higher his expected share of the vote is. (2) Contributions from an interest group to politicians increase the likelihood that they vote for legislation that benefits the interest group. Both of these propositions follow logically from the assumptions that politicians and interest groups are rational actors. Why would an interest group give money to a politician, if it would not affect the way that she is likely to vote on legislation of concern to the interest group? Why would the politician accept the money and spend it, if it did not increase the probability of her reelection? A large literature within public choice provides considerable empirical evidence for these two logical propositions.[12]

If an interest group wants to buy a piece of legislation in the United States, it must purchase the votes of at least 223 members of the House of Representatives, 51 Senators, and if it does not want the legislation to be vetoed, it had better contribute something to the president's campaign. Although the empirical literature implies that an individual Congressman's vote can be bought relatively cheaply, the sum over all required representatives is likely to be quite large.

If an interest group wants to buy a piece of legislation in Austria, it must purchase the votes of only two parties. Although it is reasonable to assume that it costs more to buy the vote of a party than of an individual member of a party, it is also reasonable to assume that there are some economies of scale in buying votes from parties than from individuals. Thus, the cost of buying a piece of legislation in a multiparty parliamentary system of the type found in Continental Europe is cheaper than in the United States. Interest groups can be expected to buy more legislation in Continental Europe than in the United States, and thus to be politically more powerful than in the United States.

When a member of Congress is defeated, or retires, or dies, the past investments by an interest group in buying this Congressman's vote are wiped out. It must begin again to establish an exchange relationship with this Congressman's replacement or with some other member of Congress. Parties in parliamentary systems seldom die or are defeated in the sense that they fail to win any seats in an election. Thus, once an interest group has established an exchange relationship with a particular party in a parliamentary system, it can most likely maintain this relationship over time with relatively modest further investments. This feature of parliamentary systems again implies that interest groups are politically more powerful in Continental Europe than in the United States.

In a multiparty system parties take positions across the full ideological spectrum. Thus, an interest group can readily find a party whose ideological position comes reasonably close to its own. This proximity of ideological positions should make it easier for an interest group to establish an exchange relationship with a party, and reinforces the prediction that interest groups are more powerful in Continental Europe than in the United States.

A fourth reason to expect interest groups to be more powerful in Continental Europe exists in countries like Austria and Germany with corporatist histories. Interest groups in corporatist countries are formally part of political decision process. In Austria, for example,

the leaders of some unions are also members of parliament. Legislation, which materially affects the welfare of a particular interest group, often formally or tacitly requires its approval. Since virtually all groups of workers are represented by well-organized unions, and no or at best weak interest groups exist to represent stockholders, it is not surprising that the latter fair poorly in any political battles involving the two groups.

When the British colonized large parts of the world in the 18th and 19th centuries, they brought with them not only their common law legal institutions, but also their political institutions. The salient characteristic of these political institutions relative to those of the Continental European multiparty systems is that in Anglo-Saxon countries voters are allowed to elect only one representative from the particular electoral district in which they reside, whereas in the Continental European multiparty systems voters elect several representatives from much larger electoral districts, with the Netherlands being the extreme case of the entire country being defined as a single electoral district. Within any district the seats are divided among the parties in rough proportion to the votes each party receives.[13] Thus, in multiparty systems, the voter's attention is drawn more toward the characteristics and platforms of the various parties competing for votes than to those of individual candidates. In single-member-district systems, voters can be expected to consider both the characteristics of the individual candidates and of the parties to which they belong.

Thus, the reasoning presented above for why interest groups should be politically weaker in the United States than in Continental Europe can be extended to predict less political influence for interest groups in other countries with single-member-district electoral systems, i.e., other Anglo-Saxon countries.[14] Within the family of Anglo-Saxon countries, however, the United States is unique in having a presidential system, which grants the president strong veto power. Because of this strong veto power, a party cannot implement particular policies merely by obtaining a majority of seats in one House of Congress or even

in both Houses. This being the case, US voters have less reason to vote for particular parties in Congressional elections to obtain what they want. Parties become weaker and the personal characteristics and promises of individual candidates become more important. In British-style parliamentary systems there is no president with veto powers, and a party can implement particular policies if it obtains a majority of seats in the parliament. Thus, in British-style parliamentary systems voters can be expected to give more weight to the party identifications of the candidates than in the United States. These considerations lead us to expect that in general interest groups will be more powerful in the other Anglo-Saxon countries than in the United States, although less powerful than in countries with multiparty systems.

Persson and Tabellini (1999, 2000, 2003) have developed a somewhat different, but complementary, argument to the one just presented. They predict that the state sector will be smaller in majoritarian systems of the British type than in proportional representation, multiparty systems, because the competition for votes focuses on the marginal districts rather than the entire nation, and thus politicians tend to make more targeted and in the aggregate smaller commitments in majoritarian systems. Although the emphasis of Persson and Tabellini is more on the supply than on the demand side of providing legislation, if we think of the demanders of legislation as being interest groups rather than individual voters, then their thesis also implies that interest groups in aggregate get more of what they want and thus can be said to be more effective at getting what they want in multiparty systems.

IV. Is There a Best Corporate Governance System?[15]

In a recent symposium on globalization, Dowrick and Golley (2004) point out that levels of national income can be regarded as very long-run measures of economic growth under the assumption that all countries essentially started off at the same low level of income.

Using this measure of performance, all of the main forms of corporate governance systems described above must be deemed to be good, since the countries which typify each – the United States, Sweden, Germany and France, and, if we add in an Asian category, Japan – have all become very rich. This is essentially the conclusion Shleifer and Vishny (1997) reached in their comprehensive survey of the corporate governance literature. Each system has its particular strengths and weaknesses.[16]

Although I agree that each system has its strengths and weaknesses, I do not draw the same conclusion that no system is superior to the others. For much of the 20th century, companies in the major industrial countries did not face domestically the intense international competition that they do today. Japan still has a fairly closed economy. The *relatively* weaker competitive environment in the domestic economy over the first three quarters of the 20th century may have concealed weaknesses in corporate governance institutions that have only become apparent in the last couple of decades. The evidence reviewed in section II, which comes from this most recent period, clearly implies that institutions in Anglo-Saxon countries – and these presumably include corporate governance systems if they are not exclusively confined to them – are better at protecting shareholders than institutions in non-Anglo-Saxon countries, and there is some evidence that they lead to better macroeconomic performance. This suggests that countries, which do not possess Anglo-Saxon institutions might achieve better economic performance by adopting them. Have political leaders realized this? Have corporate governance systems begun to converge? We now briefly look at some evidence.

V. Are Corporate Governance Systems Converging?

A. The United States

Even before the Enron and WorldCom scandals at the beginning of the 21st century,

several changes had taken place in the United States that tended to strengthen the hands of shareholders vis-á-vis managers. Some of these were precipitated by the increasingly important role of institutional investors, some by the results of Securities and Exchange Commission rulings and court decisions (see, Bradley, Schipani, Sundaram, and Walsh (1999, pp. 67-68, hereafter BSSW). The Enron scandals sped these changes along and brought the U.S. Congress into the picture. Thus, the Anglo-Saxon corporate governance model, as it is embodied in U.S. institutions has, if anything, been becoming more Anglo-Saxon.

B. Continental Europe

Several countries have introduced new corporate governance codes in the last few years, and these generally entail a movement towards the Anglo-Saxon institutions.[17] Often the movement is only partial, however. In the recently issued corporate governance codes of Austria and Germany, for example, it is only *recommended* that managers report their compensation. Nevertheless, the direction of change is unmistakable. Prohibitions against insider trading are on the increase, and companies are being forced to make their financial statements more transparent. Indeed, a large majority of the world's leading countries has adopted accounting standards that are either identical to or come close to those formulated by the International Accounting Standards Committee. The necessity to raise large amounts of capital to finance cross-border acquisitions has also led many Continental European firms to list their securities on the London or New York stock exchanges, thereby subjecting them to Anglo-Saxon corporate governance constraints even though their main headquarters remains outside of one of these countries.[18] Within the last year the Commission of the European Union has put forward a corporate governance code, which it *recommends* that all member countries adopt. *If* they were to do so, corporate governance systems in Europe – at

least on paper – would have reached full convergence.

VI. Will Corporate Governance Systems Achieve Full Convergence?

A. No

Ownership structures change very slowly over time. The best predictor of the identity of a firm's largest shareholder and the size of her/its shareholding today are the identity and size of the largest shareholder's shareholding last year. Bebchuk and Roe (1999) identify two causes for this path dependence. One they label *structure-driven* and the other *rule-driven path dependence*. Structure-driven path dependence can arise either because an organization has adapted to a particular ownership structure and thus would sacrifice efficiency by changing, or because certain stakeholders – like the managers or the dominant shareholder – would lose from a shift to a more efficient structure, and thus resist such a change. Rule-driven path dependence can arise for similar reasons. A country may adopt laws and regulations that are designed to make companies with the existing ownership structures most efficient, and/or influential managers and shareholders may be able to induce the political system to maintain a set of rules, which, although inefficient, is to their advantage.

Barca and Trento (1997) give an account for why banks in Italy play such a modest role in its corporate governance structure, which illustrates the importance of path dependence.[19] During the first part of the 20th century, banks in Italy played much the same role in financing and monitoring firms as they did in Germany. The stock market crash at the end of the 1920s produced a crisis for the banks, however. The state rescued the banks by buying out their industrial holdings and placed them into a newly corrected state-owned company – the Institute for Industrial Reconstruction (IRI). At the same time the government passed legislation resembling the Glass-Steagall Act in the United States limiting banks'

involvement in the industrial sector. Thus, the weak role played by banks in corporate governance in both the United States and Italy can be traced to essentially the same event at the same point in time.

B. Yes

If the best practice technology in an industry is characterized by a U-shaped average cost function, then perfect competition will ensure that every firm in the industry adopts the best practice technology, *and* that every firm is of the size defined by the bottom of the U. If globalization is increasing competitive forces in every country, then the obvious implication would seem to be that countries should converge on the "best practice" corporate governance system. In an article that has received much attention, Hansmann and Kraakman (2001) have made such a prediction. They see the efficiency enhancing aspect of competition in capital markets driving convergence on the Anglo-Saxon system.[20]

C. Maybe

Although one cannot rule out the possibility of a full convergence of corporate governance institutions on a single, Anglo-Saxon model, the analogy between competition within industry leading to convergence among firms and competition across countries leading to convergence of countries' institutions is somewhat problematic. In a competitive environment inefficient firms go bankrupt and disappear. Countries seldom go bankrupt and only disappear if they are defeated in war. The greater efficiency and faster growth that are likely to follow reforms in corporate governance should tempt politicians to introduce these reforms, but there will be counter pressures resisting such reforms, and it is by no means clear that all countries' governments will resist these pressures.

In the first study in which I estimated marginal qs, I used a sample of nearly 700 US

corporations and data for the period 1969-88 (Mueller and Reardon, 1993). The results for the US over that period were much the same as those reported in Tables 1 and 2 *for the civil law countries.* Eight out of ten large US corporations had a marginal *q* less than one, with the mean being just over 0.7. The estimated marginal *q*s for US firms were much higher in the late 1980s and 1990s. I attribute this improvement in performance to an important degree to the hostile merger wave of the 1980s. The poor performance of US managers was recognized by the market, and *for the first time* was corrected by "the market for corporate control" as Marris (1964) and Manne (1965) had predicted 20 years earlier. That wave of hostile takeovers made managers more attentive to shareholder interests, led to "downsizing," returns to "core competencies," share buy backs, and the like, all to the benefit of corporate shareholders. The hostile merger wave had a second, important consequence, however, it drove managers to approach state legislatures and demand legal protection from hostile takeovers, and to threaten them with migration if they did not comply. Naturally, almost all complied (Romano, 1987; Roe, 1993; Bebchuk and Ferrell, 1999).

Good corporate governance structures benefit shareholders by reducing managers' discretion to pursue their own goals. Both managers and workers have an interest in seeing their firms grow, or at least survive. If national governments are more sensitive to the interests of corporate managers and workers than to shareholders, reforms in corporate governance system may not take place, or be implemented. A recent EU Commission proposal to make takeovers easier has been significantly weakened by pressures from member countries' governments, which in turn were presumably responding pressures from their largest companies (*Economist*, 2003). Recent state interventions in France to save national champions Alstrom from bankruptcy and Aventis from the clutches of a foreign company give one a certain sense of *déjà vu*, to a time when no European common market existed and national governments were totally free to respond to domestic political pressures

and pursue their industrial policies oblivious to their impacts on other countries.

The policy implications of the work of LLSV (1997, 2000), Mahoney (2001), and myself and my colleagues (GMY, 2003, 2004b) would appear to be that if France and Italy wish to have a better economic performance over the next 20 years than they have shown over the last 20, they had better adopt Anglo-Saxon legal institutions. Install a common law, adversarial legal system and scrap their civil law systems. If this is the bottom policy line of these studies, then it is discouraging news for all civil-law system countries, since institutional changes of this order of magnitude are virtually impossible to achieve. The civil law countries would appear to be doomed to second class economic citizenship in the globalized world of the 21st century.

Fortunately for the civil law countries, legal reforms to improve corporate governance should be possible without having to revamp the entire legal system. We have observed significantly better investment performance in civil law countries, if they have strong accounting standards and strong contract enforcement (GMY, 2003, 2004b). Reforms such as these should be within the reach of every country, *if* it has the political will to introduce them. The main obstacle to institutional reforms in Europe must be seen as political.

Mark Roe (2003) is certainly correct in stressing the importance of ideological differences between the United States and Continental Europe in explaining differences in their corporate governance systems. In Austria, France, Sweden and I would guess most if not all Continental European countries, anyone who is favorably disposed to market institutions or globalization is automatically labeled a *neo-liberal,* and the term "neo-liberalism" invariably carries with it a negative connotation. Neo-liberalism is also generally identified as an American ideology. Thus, there is an underlying ideological aversion to American economic institutions in Continental Europe that stands in the way of a full adoption of the American or Anglo-Saxon model of corporate governance.

I have argued, however, that more stands between the Anglo-Saxon and Continental European countries than just ideology. Politicians in all countries seek to win public office, and once elected to be reelected. Politicians like everyone else respond to incentives. Political institutions, like electoral rules, give politicians different incentives – and they respond to them. The political institutions of Continental Europe make interest groups like labor unions much more powerful than in the Anglo-Saxon countries, and this difference helps to explain the differences in economic institutions and outcomes in these two sets of countries. If I am right about this, then this conclusion is even more discouraging than attributing these differences to legal institutions, for laws, and by implication, legal institutions are easy to change compared to political institutions. Changes in laws that affect corporate governance do not affect politicians directly, but only through their indirect effects on voters' preferences. Changes in laws that govern elections, on the other hand, will generally affect politicians and parties directly, even if they have no effects on voters' preferences. Any fundamental change in electoral rules is almost certain to be strongly opposed by one group of parties. Since the parties themselves generally must introduce such changes, it is not surprising that they seldom occur. Fundamental changes in political institutions are seldom observed save following a revolution or defeat in war.

On this somber note I shall bring this essay to a close. If fundamental improvements in economic outcomes do require fundamental changes in political institutions, they are unlikely to come about. Change must come about in the preferences and ideologies of individual voters and interest groups. An optimist can see such changes in Europe today. Germany's largest labor union has just agreed to a new contract *increasing* the number of hours per work week. French labor unions seem willing to move away from their beloved 35 hour work week. Such instances of economic enlightenment, or perhaps more accurately pragmatism, are indeed encouraging. But such reforms are fragile, and even a partial victory

for economic liberalism seems still a long way off. A global economic crisis, as say

following terrorist attacks on the oil fields of Middle East, could easily rekindle the anti-

market, anti-liberal ideological fires in Europe.

Endnotes

1. See, for example, Gilson and Roe (1993), and Charkham (1994).

2. See, for example, LaPorta, Lopez-de-Silanes, Shleifer and Vishny (1997, 2000) (hereafter LLSV), and Gugler, Mueller and Yurtoglu (2003, 2004b) (hereafter GMY).

3. Early contributions to this literature include Mueller (1969, 1972), Baumol, Heim, Malkiel and Quandt (1970), and Grabowski and Mueller (1972, 1975). Two recent empirical tests of the hypothesis are Stulz (1990), and Denis, Denis and Sarin (1997).

4. The methodology for estimating these marginal qs was first presented in Mueller and Reardon (1993).

5. See Jensen and Meckling (1976), and Modigliani and Perotti (1997).

6. When the Anglo-Saxon and French-origin samples are expanded to include countries in lower stage of development, the Anglo-Saxon sample does exhibit a much higher growth rate than the French-origin sample (4.30 versus 3.18 percent) (GMY, 2004a, Table 3).

7. Schumpeter (1934, pp. 93-4). The reference is to the 1934 translation of a book originally published in German in 1911.

8. Boehmer (2001) claims that German banks are not interested in shareholder value.

9. See discussion in Mueller (2003, pp. 98-105).

10. Managerial entrenchment is also assumed to increase with firm size, because it is more difficult to launch successful proxy fights or hostile takeovers against large firms.

11. This subsection draws heavily on Mueller (2002).

12. See, Mueller (2003, ch. 20).

13. France is the major exception to this rule. It is also divided into single-member-electoral districts, but uses a two-stage, "majority system" to elect representatives rather than the one-stage, plurality system common in the Anglo-Saxon countries. For further discussion and references, see Mueller (2003, ch. 13).

14. New Zealand had an Anglo-Saxon, plurality system up until the election of 1996, when it adopted electoral rules to produce a proportional representation system. The reasoning of this section predicts ceteris paribus an increase in interest group power in New Zealand after 1996, although presumably with some time lag.

15. The last two sections of the paper draw heavily from GMY (2004b).

16. Kester (1992) takes a similarly equivocal position.

17. For the codes of nearly 40 countries, see http://www.ecgi.org/codes/all_codes.htm.

18. For further discussion of these developments and references to the literature, see BSSW (1999, pp. 69-74).

19. Mediobanka has been an exception to this generalization, however.

20. Palepu, Khanna and Kogan (2002) find evidence of *de jure* convergence at the country level. This convergence is, however, not on US standards. Rather, pairs of economically interdependent countries appear to adopt common corporate governance standards, especially if the pairs of countries are in the same geographic region and are relatively developed countries.

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