

Essay:

Since the 1980s there has been a partial convergence between the shareholder-based and the stakeholder-based systems of corporate governance. What has caused this convergence and is it likely to continue?

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Introduction

One could hardly deny that we are living in an increasingly globalising world. The success of both advanced and emerging markets to integrate into this global economy depends among others on the corporate governance issues (Owen, 2004). There is no wonder therefore, that existing systems in corporate governance, their efficiency and possible transformations are in the centre of debate among economists and politicians. This paper intends to discuss the two major models of corporate governance. The first part of the paper is dedicated to comparative analysis of the models. The second part, will address the causes of partial convergence between the shareholder-based and stakeholder-based views. Finally, the paper will conclude with the discussion of possible future trends in corporate governance.

Major systems of corporate governance: which one is better?

Since Berle and Means (1932) formulated the conflict of interest between managers and shareholders in a company, the agency problem has been an essential part of corporate governance. Indeed, according to Shleifer and Vishny (1997), the fundamental question of corporate governance is how to assure suppliers of finance that they get a return on their investment. This approach is known as the *shareholder-based model* of corporate governance. In practice, the issue of corporate governance appears to be more complex. A whole set of different groups, such as employees, customers, suppliers and society at large constitute the framework within which the governance should be considered. The approach, which is to insure that the managers meet the interests of both shareholders and also other stakeholders, is the second major view in corporate governance, respectively referred to as *stakeholder-based model*.

According to Maassen (2002), there are three principal characteristics of effective corporate governance: transparency of information, protection of the rights of all shareholders, and lastly, capability of directors to independently hire, monitor and replace managers where necessary. However, Sheridan and Kendall (1992), suggest that different countries have different ideas about what makes good corporate governance. Indeed, shareholder-based system is otherwise referred to as Anglo-American model, apparently indicating the countries which prefer that type of governance. Whereas continental Europe and parts of Asia (particularly Germany and Japan) are in favour of stakeholder-

oriented corporate governance. The reasons for preference of a certain structure are explained differently by two polarised views: neo-classical and path-dependent. Neoclassical economists insist that firms choose their corporate structures based on simple efficiency considerations: the most efficient ones are chosen accordingly. Path dependence assumes that corporate governance structures are deeply rooted in countries' historical traditions and initial ownership structures of organisations. (Bebchuk and Roe 1999). Meanwhile, Roe (1994) goes further to develop political theory underlying the differences in ownership structures. Specifically, the author states corporate governance structure is formed not only by legal limitations on the control of financial organisations, and moreover that these limitations are not all technical, but often have political explanation. So the U.S. has chosen to have a financial system where the power of financial institutions, such as banks and insurance companies, is quite limited. A relatively recent example with former Soviet Union countries effectively shows, how the new political power determines new economic environment, and particularly ownership structures after the collapse of soviet regime.

According to Odenius (2008), shareholder-based system is common in countries with dispersed ownership structures, i.e. Anglo-Saxon countries, while the stakeholder-based system in continental Europe and Asia is associated with concentrated ownership structures. The latter is also known as relationship-based system, meaning that ownership of most publicly quoted companies is in the hands of few long-term committed shareholders, directly involved in governance (Owen, 2004). The large number of investors here is less prevalent, and the owners are very often represented by families or few individuals. Prowse (1995) reports, that Japan and Germany have respectively 33.1% and 41.5% of outstanding shares owned by the largest five shareholders, whereas in the United States and United Kingdom the figures are as low as 25.4% and 20.9% accordingly.

Among the main characteristics of the corporate governance systems is the structure of the board of directors of the firm. In Anglo-American model, it is rare that the CEO is not on the board, and he/she effectively holds tremendous power (Allen and Gale 2000). In contrast, the German model of codetermination and dual board ensures that employees are represented in the board of directors, thus sharing the power with the managers and owners.

There is a great deal of disagreement among researchers about superiority of either of the existing corporate governance mechanisms. Throughout 1970s and 1980s many observers have criticized quite strongly the U.S. corporate governance system. Instead, they looked to other systems, particularly the German and Japanese ones, as being superior (Holmstrom, Kaplan 2001). One of the strong advocates among them is Porter (1992), who argues that Anglo-American pattern of dispersed ownership is clearly inferior to the bank-centred capital markets of Germany and Japan, because the latter enables corporate executives to manage for the long-run. According to Roe (1994), the efficiency of German and Japanese corporate governance systems came to acknowledge that American-style public firm with fragmented shareholder power is not inevitable. The author assumes the reason is the discouragement of the large investors in the States.

In contrast, authors such as Easterbrook and Fischel (1991) and Romano (1993) make a very optimistic assessment of shareholder-based system. Stiglitz (1985), for example, argues further that concentrated ownership is one of the most effective ways to ensure value maximisation by firms. Schleifer and Vishny (1997) emphasise that American firms are able to raise capital in the stock market better than firms elsewhere in the world. Hence it is difficult to perceive the U.S. corporate governance system as inefficient. Yet again, permanent large shareholders and banks dominating corporate governance in Japan and Germany, apparently have advantages of influencing corporate management.

Further, Schleifer and Vishny (1997) conclude that a good corporate governance system would include both legal protection of minority investors and some form of concentrated ownership, i.e. large investors. Large investors appear to be crucial to force managers distribute profits.

Moreover, the recent scandals associated with each type of the corporate governance structures, seem to add to the lack of the dominance of either of the systems. The examples with Enron and Worldcom display how in dispersed ownership systems managers can enrich themselves at the expense of shareholders. Similarly, the scandal around Adelphia and Parmalat implies that in concentrated ownership systems controlling shareholders may enrich themselves at the expense of the minority (Enriques, Volpin 2007).

Causes of convergence

Partly because there is no obvious “winner”, and partly because of legal and economic transitions taking place, a partial convergence of the two models of corporate governance seems to take place. The growing popularity of large shareholders in the U.S., the emergence of public debt markets in Japan and increasing bank-bashing in Germany, are, according to Schleifer and Vishny (1997), a clear evidence of convergence. The history of it can be traced back to 1980s, when certain developments were identified.

First of all, it is important to mention the **growth of European stock markets**. They have traditionally been characterised by relatively few initial public offerings (IPOs). This can be explained by the existence of obvious “interest groups”: e.g. banks in Germany do not want rivals, and hinder the growth of securities industry. However, there is a growing political and economic awareness in these countries, that bank-centred finance and family-owned businesses might be the cause of decreased economic activity. A series of measurements have respectively been initiated to promote activity in stock markets. Specifically, in Germany, these included prohibition of insider trading, the establishment of the Federal Securities Supervisory Office (Odenius, 2008), as well as large privatizations of formerly state owned firms, such as Deutsche Telekom (Coffee, Berle, 1999).

Secondly, **harmonization of securities regulation and disclosure rules** has significantly contributed to achieving a common market of securities in Europe. Since early 1980s, the EU has adopted a series of securities-oriented directives governing (1) the minimum requirements for the admission of securities for trading on a stock exchange in any EU member state, (2) the minimum disclosure requirements for securities offerings in any member state; and (3) periodic reporting requirements. These steps represent substantial convergence at the level of securities regulation (Coffee, Berle, 1999). Moreover, a series of corporate governance law reforms in 1990s both in Germany and in Italy have been aimed at strengthening mechanisms of internal governance, increasing public enforcement, enhancing disclosure requirements and empowering shareholders (Enriques, Volpin 2007).

Thirdly, 1980s were characterized by the **transition towards investor capitalism**. More interventions were made by institutional investors, such as pension funds and mutual funds, and more hostile take-overs occurred (Owen, 2004). Pension funds regulations as

well as liberal tax laws, which were passed in Italy, have aided the activity of such institutions. And although similar reforms in Germany and France meet political resistance, the process is in ongoing growth (Coffee, Berle, 1999).

Additionally, the **harmonization of International Accounting Standards** has also played a significant role in partial convergence of the two models. It has eliminated the need to reconcile financial statements in the world's securities markets. This step has specifically contributed to issuing securities in foreign markets, i.e. U.S., which created incentives for companies with concentrated ownership to consider alternatives for raising and investing capital, as well as increasing their stock price. This fact has also contributed to increased migration to foreign markets worldwide.

Finally, many researchers believe that with **increased globalisation** and hence cross-border competition, there is a natural fear among small, family-owned companies that they will consequently be "eaten" by the big ones. Thus European firms increasingly perceive themselves under a need to grow in order to survive in the global economy. In this situation, the managers shift the focus to shareholder value, apparently to make the companies more profitable and desirable for the investors.

However, there is a group of path-dependence theorists, still sceptical about convergence of the two models in corporate governance. Particularly, Bebchuk and Roe (1999) argue that differences in the nature of firms and markets, as well as culture, ideology and political orientation might well continue to impede convergence of corporate structures. Coffee and Berle (1999) mention that political resistance to change by different interest groups will be among the obstacles to convergence.

What to expect in the future?

It can be noticed, that the whole idea of convergence, wherever we agree with it or not, tends to emphasize the tendency towards shareholder-based, rather than stakeholder-based model. And although it is true, that the praise for a certain model has largely depended on the relative performance of representative countries in a certain period, there seems to be more support for Anglo-American model.

With this regard, Karmel (1991) states that increased global competition will force a quick convergence specifically towards the U.S. pattern. The reason behind, she thinks, is the fact that there is a continuous trend in Europe to better protecting the rights of shareholders.

A somewhat similar conclusion is drawn by Coffee and Berle (1999). They argue that a functional, rather than formal convergence of corporate governance models is to take place in future. Particularly, the functional convergence would mean further development of international securities markets, which in turn would lead to growing migration of firms to U.S. equity markets.

On the other hand, in some emerging markets, like India, as well as in advanced economies such as Germany and Italy, the role of internally financed and family-controlled firms might continue to be quite relevant (Schleifer and Vishny 1997). It is interesting to note, that the latter trend is the result of not only political and legal path-dependence, but is also due to better governance and ease of management considerations (Enriques, Volpin 2007).

In the light of a more conservative view, the corporate governance systems worldwide will still remain diverse (Odenius, 2008). Corporate governance in Anglo-Saxon countries will still pursue to maximise shareholder value, while continental Europe and Asia will continue to target stakeholder value. This, the author thinks, will happen despite the recent reforms that strengthened shareholder value considerations.

Perhaps the most liberal approach to the future of convergence is best described by Hofstetter (2005). He concludes that system selection should be left to markets as final “arbitrators”. Therefore the challenge will be to devise regulatory frameworks within which the open competition between different forms of ownership structures can take place without distortion.

Conclusion

There is a great deal of disagreement among researchers about superiority of either of the existing corporate governance mechanisms. What seems to be unanimously accepted though, is the apparent trend towards convergence between the two. The causes of such convergence include increased demand to compete in the global economy, shift to investor capitalism, growth of European stock markets, reforms toward harmonization of legislation and financial disclosure rules, and many more. Surprisingly, despite the convergence there are still undeniable advantages that each of the models displays. Thus a complete convergence does not seem to be feasible in the nearest future. And as long as neither of the countries is entirely satisfied with the efficiency of its corporate governance model, the reforms will be ongoing, and so will the competition between the models.

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