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Political Preconditions to Separating Ownership From Corporate Control

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Tables

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The large public firm dominates business in the United States despite its critical infirmities, namely the frequently fragile relations between stockholders and managers. 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 the continental European social democracies. Social democracies press managers to stabilize employment, to forego some profit-maximizing risks with the firm, and to use up capital in place rather than to down-size when markets no longer are aligned with the firm's production capabilities. Since managers must have discretion in the public firm, how they use that discretion is crucial to stockholders, and social democratic pressures induce managers to stray farther than otherwise from their shareholders' preference to maximize profits. Moreover, the means that align managers with diffuse stockholders in the United States—incentive compensation, transparent accounting, hostile takeovers, and strong shareholder-wealth maximization norms—are deliberately harder to implement in continental social democracies. Hence, public firms there will, all else equal, have higher managerial agency costs, and large-block shareholding will persist as shareholders' next best remaining way to control those costs. Indeed, when we line up the world's richest nations on a left-right 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 absence both of a strong social democracy and of the concomitant political pressures it would have put on the American business firm.

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Introduction: Why Do Only Some Nations Have Public Firms?

The public firm, with dispersed stockholders in deep liquid securities markets, dominates business in the United States. Despite its pervasiveness, it has well-known infirmities, namely in the fragile ties that bind managers to shareholders. If shareholders strongly fear managers' disloyalty or incompetence, they will invest warily; if sufficiently fearful, they will not invest at all, and other ownership structures will prevail. But the core problems of binding managers to shareholders in the United States have shrunk to acceptable levels; investors are not so afraid of managers that they refuse to invest. Indeed, these problems have been handled so well that we fail to recognize the political prerequisites to resolving them and tying American managers to dispersed stockholders.

I argue here that the core problems of the public firm cannot be resolved readily, or at all, in a strong social democracy. Social democracies press managers to "defect" from loyalty to shareholders and make it harder to align managers with shareholders. When we see how social democracies weaken shareholders' ties to managers, we shall thereby discover the critical political prerequisite to the rise and persistence of the public firm in the United States, namely the absence of a social democracy and its concomitant powerful pressures on the business firm.

* * *

In contrast to the American-style public firm, the family firm, or the public firm with concentrated ownership, dominates business in France, Germany, Italy, and Scandinavia. How do we explain this difference, and its persistence? The issue is a live one among European policy-makers and academics, who see Europe's inability to develop rich and deep securities markets as stymieing innovation and reducing competition.[1]

Diffusely-owned public firms must make managers loyal to shareholders. Agency costs arise from managers having agendas that differ from shareholders' agendas. Diffuse shareholders want the firm to maximize profits; managers often prefer to maximize the firm's size, prefer not to take severe risks with the firm even if the risks would maximize profits, and often

[1] Cf. Colin Mayer, Financial Systems and Corporate Governance: A Review of the International Evidence, 154 J. Inst. & Theoretical Econ. 145, 145 (1998) ("In Continental Europe, there is concern that existing systems of [corporate] governance are stifling innovation and growth."); European Corporate Governance Network, Country-by-Country Reports (1998) (weak securities markets and few public firms impede European economic development).

prefer to defer hard, disruptive actions. When blockholders and private ownership persist, they may persist because they serve a function for shareholders. Blockholders and private owners have the means and the motivation to monitor managers, a motivation and an authority that dispersed shareholders in the Berle-Means corporation often lack. Hence, blockholding may persist on the continent because managerial agency costs are potentially higher there and stockholders lack good alternative means of keeping managers loyal.

Most corporate governance analyses ignore employees, and when we put them back into the governance inquiry, we get a richer understanding of how a society organizes its corporate institutions: Social democracies and the American-style public firm mix badly because public firm agency costs in social democracies are higher *and* the mechanisms that would control the agency costs are harder to implement.

A tension always exists between current employees and invested capital, and a great deal of corporate governance mitigates this tension. It does so by inducing managers to act in shareholders' interests, and, oftentimes, against the immediate interests of employees with jobs in place. When economic realities change, employees could be laid off. When technologies change, managers must alter the firm's structure and day-to-day working environment in ways that make incumbent employees and often the managers themselves unhappy. Employees' and managers' jobs must be restructured or put at risk. Work, if the excitement of change is unattractive, becomes disruptive, difficult, and risky; workers and managers may resist change. Managers, for their own reasons, not only frequently delay these restructurings, but also have a long-known propensity to expand the firm's ongoing operations, even at the cost of shareholder profits; their expanding the firm down a known path usually favors themselves and current employees, but it often fails to maximize shareholder profits.

In social democracies—nations committed to private property, whose governments play a large role in the economy, emphasize distributional considerations, and favor employees over capital-owners when the two conflict[2]—public policy emphasizes managers' natural agenda and demeans

[2] Adam Przeworski, Socialism and Social Democracy, *in* The Oxford Companion to Politics of the World 832, 835, 837 (Joel Krieger et al. eds., 1993) (social democracies seek "to implement 'functional socialism,' even if ownership of productive resources remains private"); S.C. Stimson, Social Democracy, *in* 4 The New Palgrave—A Dictionary of Economics 395 (John Eatwell et al. eds., 1998).

shareholders' natural 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—high incentive compensation, hostile takeovers, transparent accounting, acculturation to shareholder wealth maximization norms—are weak. Life may well be better for more people, but the internal structure of public firms must necessarily be weaker for shareholders.

Hence, managerial agency costs are higher in social democracies than elsewhere, and we have just found a deeper, richer social and 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 well, because they do *not* want unbridled shareholder wealth maximization, and, hence, by weakening shareholder wealth maximization institutions, they widen the gap. When the gap is wide enough, the large American-style public firm is rendered unstable without subsidy, making it incompatible with social democracy. Social democracies may improve aggregate welfare, but they do so with fewer public firms.

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A road-map for this article: In Part I, I first set out the structural contrast in ownership around the world and next show how social democracy both (a) wedges open the gap between managers and shareholders and (b) raises the costs of closing the gap. In Part II, I show some fundamental correlations: if we array the world's richest nations along a left-right spectrum, this spectrum correlates powerfully with ownership concentration. I also briefly discuss the reasons for American exceptionalism. In Part III, I discuss stronger tests and provide alternative formulations of the thesis. In Part IV, I analyze why the leading non-political explanations are theoretically ambiguous, empirically dubious, or both; weak corporate law, a leading explanation, can indeed disable the public firm, but the reasons why it can are inapplicable to most of the world's richer nations. I also discuss reservations to the political thesis, rebut several, and concede a few of its limitations. In Part V, I explicitly draw out the implications for understanding the American public firm. Finally, I conclude.

I. Social Democracies' Pressures on the Public Firm

Some nations' large firms are diffusely-held, while others are closely-held, because many never go public, and big blockholders persist even in those that do. In Germany, nearly every large firm has a large blockholder, usually from a family, but for some firms from a bank, an insurance company, or another corporation.[3] In France, the family sector is large, growing, and highly competitive.[4] In Italy family firms persist and few firms are truly public.[5]

Once one might have seen the differences as due to size, in that American firms were larger, and only the largest became truly public firms. But even among similarly-sized large firms, the public firm is *still* more widespread in the United States than in continental Europe.[6] These differences persist, despite converging living standards and business technology.

No single factor can fully explain every difference and I discuss the conventional explanations below in Part IV. I do not wish to displace the other explanations completely, but rather to make space, and a rather large one, for the unrecognized political explanation and show why the political explanation is as, or more, important for the world's richer nations as any current explanation.

A. Agency Costs and the Public Firm

The United States has a rich literature on agency costs, of the disjunction between managers' goals and shareholders' goals.[7] Shareholders, particularly diversified shareholders who are distant from the corporation, want their firm's profits maximized. Managers historically preferred to

[3] Julian Franks & Colin Mayer, Ownership, Control and the Performance of German Corporations (unpublished manuscript presented at the Columbia Law School Sloan Project Conference, April 1997); Ekkehart Böhmer, Who controls Germany? An exploratory analysis (Universität Osnabrück Arbeitspapiere Nr. 71, October 15, 1998).

[4] Paul Windolf, The Governance Structure of Large French Corporations, *in* Corporate Governance Today 705 (1998) (Columbia Sloan Project on Corporate Governance).

[5] Cf. Eugenio Ruggiero, Italy, *in* The Legal Basis of Corporate Governance in Publicly Held Corporations: A Comparative Approach 79, 82 (Arthur R. Pinto & Gustavo Visentini eds., 1998) (*declining* number of listings in 1990's on Italy's leading stock exchange).

[6] Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, Corporate Ownership Around the World, 54 J. Fin. 471 (1999).

[7] Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976); Adolf Berle & Gardiner Means, The Modern Corporation and Private Property (1933).

expand their firms,[8] as expansion yielded them more power, prestige, and pay.[9] Managers, with their own human capital tied up in the firm, often wanted to avoid many profit-maximizing risks; shareholders, who can diversify better than managers, have usually preferred their firms to maximize expected value, without respect to risk. Managers often used up capital in place rather than restructure a firm, because restructuring can be painful. And in simple terms managers may not have wanted to work as hard and as long as shareholders would prefer.

Corporate governance is traditionally seen in the United States as a principal-agent problem. Principals cannot get agents to perform perfectly. The principals often are less well informed than their agents about the tasks to be performed and, afterwards, about how well the agents performed them. The principals may be more time-constrained than the agents in the activity involved. Stockholders as principals cannot automatically get their agents, the firm's managers, to pursue stockholders' interests. In the United States, the public firm principal-agent problem is layered over a free-rider problem because the stockholders are fragmented and distant from the firm, with each unwilling to invest heavily in monitoring their managerial agents and in making those agents toe the line to perform for shareholders. This much is not new.

That is, when stockholding is diffuse, these agency cost problems for shareholders increase, because diffuse, free-riding shareholders lack the motivation to monitor managers. Moreover, their small holdings deny them the means to monitor effectively—managers have little reason to pay attention to a small shareholder acting alone—and deny them the information base they would need to be effective. Yet, despite these problems, the U.S. has many public firms, whose shares are diffusely-owned. Part of the reason this is so is well-known: diffuse ownership yields risk-bearing advantages that partly offset the agency cost disadvantages of large firms. Part of the reason is that professional managers despite their debilities are often better at their job than the second or third generation of family managers.[10]

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[8] See, e.g., John Kenneth Galbraith, The New Industrial State (1967); Jensen & Meckling, supra note 7; Robin Marris, The Economic Theory of "Managerial" Capitalism (2d ed. 1968); Oliver Williamson, The Economics of Discretionary Behavior: Managerial Objectives in a Theory of the Firm (1964).

[9] Cf. Scott Schaefer, The Dependence of CEO Pay-Performance Sensitivity on the Size of the Firm, 80 Rev. Econ. & Stat. 436-43 (1998).

[10] Alfred P. Chandler, The Visible Hand: The Managerial Revolution in American Business (1977); cf. Harold Demsetz, The structure of ownership and the theory of the firm, 26 J.L. & Econ. 375-90 (1983) (sole owner maximizes personal utility, not firm value).

And part of the reason that the U.S. has so many public firms is that it developed tools to constrain agency costs. Indeed the American agency costs may seem more vivid than they really are, because of background rates: That is, *because* the United States has many public firms, whose shares are diffusely-owned, the *concrete and visible* American corporate governance problem is to control managerial agency costs. Analysts of the American firm may be misled into thinking that the U.S. controls agency costs *badly* on some absolute scale because agency cost failures are frequent and visible. But they are visible and vivid because the United States has *so many* diffusely-held Berle-Means firms. It got so many (or was able to keep them after other forces created them) *because* it developed good institutions to control those agency costs.

These institutions have been the independent and active board, incentive compensation, hostile takeovers and proxy contests, securities markets signaling from securities analysts, competitive capital and product markets, and socialization in business schools and on-the-job to a shareholder wealth maximization norm. I hardly argue that these devices perfectly align managers with stockholders; but since the U.S. has so many Berle-Means firms with diffuse ownership, (i) we will see more agency cost failures in the United States in the aggregate, and (ii) corporate law academics and finance economists, because they correctly focus their attention on improving or understanding the core American corporate governance institutions, are susceptible to incorrectly believing that the U.S. controls agency costs badly, when the prevalence in the U.S. of the Berle-Means firm more likely shows an institution whose costs even if not trivial and even if still susceptible of improvement are sufficiently contained to be viable for all of its key players.

B. Social Democracies and Agency Costs: Raising the Stakes

Social democracies raise agency costs for shareholders in the public firm, and, to the extent they do so, shareholders' natural reaction would then be to find an alternative organizational form. German codetermination—by which labor gets one-half of the supervisory board of Germany's largest firms—is an explicit manifestation of social democracy, one that well illustrates the effects on corporate organization of social democracy. We first look at social democracy's effects through codetermination, seeing the dilemma a family-owned firm faces when considering whether to take their firm public, and then we generalize to look at social democracy's effects on agency costs and ownership structure without codetermination. The formal social democratic institution of codetermination is not needed for social democracy to affect the public firm's internal workings, but the formal institution boldly illustrates the political effects.

1. Social democracy's effects through codetermination — Germany has had a long ideological and political encounter with codetermination. It first arose after World War I when revolutionary leaders established workers' councils (counter-parts to the better-known soviets that not only arose but prevailed elsewhere), which evolved into employee representation on the supervisory council of the larger firms. After World War II, labor leaders sought to be represented on the boards, partly to convince the Allies not to dismantle Germany's coal and steel industry, by asserting that they, labor, would constrain the wartime industrialists via positions on the firms' supervisory boards. From this "deal" came full-parity codetermination of labor and shareholders in the coal and steel industry. Later political events expanded this codetermination, to one-third of the supervisory board of most other industrial firms, and in 1976 to one-half of the board of Germany's larger firms.

Codetermination also had its capitalist promoters, who sought a "middle way" between the raw capitalism of the marketplace and the extreme socialism of state-ownership. Business and political leaders such as Walter Rathenau promoted the idea,[11] and the institution has grown into one that many Germans have been proud of.[12]

Consider how codetermination affects agency costs, and thereby affects German corporate ownership structure and securities markets, by seeing how a successful family firm, thinking about an initial public offering and withdrawing from managing and owning the company, might react to codetermination. Their supervisory board has never been strong. It has met for the statutory minimum of (until recently) twice annually. The meetings are formal, without serious give and take. The accounting reports that the board gets are not very good, the board gets them at the very beginning of a semi-annual meeting, and then the reports are whisked away from them at its end.

[11] Walter Rathenau, Vom Aktienwesen __ (1922); Walter Rathenau, Die Neue Wirtschaft __ (1918). Rathenau, a leading thinker and political leader, was from the family that founded Germany's [leading] electrical company, is usually cited; he later became Germany's foreign minister.

[12] See [Interview with] Gerhard Schröder, chancelier de la République fédérale d'Allemagne, Le Monde, Nov. 20, 1999 (in contrast to the American model, "ours is founded on the participation of workers not just in our prosperity but also in decision-making, notably via codetermination").

The board is not a serious monitoring mechanism inside the firm. This is the typical picture painted of the German boardroom today.[13]

Board-level monitoring has not thus far been critical to the firm for two reasons. First, many family owners are also the firm's managers; hence, the disjunction between ownership and management is weaker than in the public firm, and agency costs lower. Second, even if the family does not manage the firm directly but hires professional managers, the family members meet monthly with managers to review results and performance. In effect, the monitoring role of the active board is fulfilled apart from the supervisory board, whose meetings are stale, formal, and ineffective.

The family may have considered moving more of the monitoring into the boardroom, partly to get ready for a public offering, partly to formalize the informal monthly meetings with managers. But they concluded not to move it inside the boardroom, because they preferred not to give more information and authority to the labor members of the supervisory board.

The family, as we've hypothesized, is hoping to leave the firm. They want to sell their stock and diversify their investments. The firm has been returning $50 million in earnings to them annually, and they accord a capitalization rate of 10 to those earnings, valuing the firm at $500 million.

The underwriters with whom they speak confirm that the firm would be worth $500 million if the average annual earnings of $50 million were expected to persist. But the underwriters, representing the potential diffuse public stockholders, say that they fear the earnings will not persist if the board remains weak, meeting only twice annually and receiving such poor

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[13] See Katharina Pistor, Codetermination: A Sociopolitical Model with Governance Externalities, *in* Employees' Role in Corporate Governance 163 (Margaret Blair & Mark J. Roe, eds., 1999); Jeremy Edwards & Klaus Fischer, Banks, Finance and Investment in Germany 213 (1994); Wulf von Schimmelmann, Unternehmenskontrolle in Deutschland, Finanzmärkte 7 (Bernhard Gahlen, Helmut Hesse & Hans Jürgen Ramser, eds. 1997); cf. Johannes Semler, The Practice of the German Aufsichtsrat, *in* Comparative Corporate Governance—The State of the Art and Emerging Research 268, 272 (Klaus Hopt, Hideki Kanda, Mark Roe & Eddy Wymeersch, eds. 1998) (some boards get good supporting information, some do not). Recent pressures, and then some legal changes, have pushed the supervisory boards to meet three or four time a year. See Thomas J. André, Jr., Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards, 70 Tul. L. Rev. 1819, 1825 n.21 (1996); cf. Nikos Vafeas, Board meeting frequency and firm performance, 53 J. Fin. Econ. 113 (1999) (more frequent meetings improve corporate performance).

information. Eventually there will be an external crisis in the firm's markets or an internal one in the firm's organization, and a weak, poorly-informed board is likely to respond more slowly and less effectively than a stronger one. Eventually current managers will retire or be unable to manage the firm well, and a weak board will resolve a succession crisis less effectively than a strong one. Thus far, the underwriters say, the family has fulfilled the role that a strong board would play. But if the family leaves, the firm will at times be rudderless.

The underwriters put a value on the weak board if the firm lacks direction from the family owners, saying that over time, they'd expect that earnings would be $40 million, not $50 million, if the board is weak and ineffective. They accord those earnings the same capitalization rate of 10, valuing the firm at $400 million, not $500 million.

The family and underwriters then consider charging up the board: they consider changing the by-laws to have the board meet monthly; they plan to improve the information flow to the board; they plan to adopt transparent, understandable accounting, with statements going to the board well before the meetings; they plan to instill in the board an ethic of involvement; and they propose to build aggressive audit, executive, and compensation committees. These improvements to the board, the family tells the underwriters, will reduce the monitoring and weak board problems, the expected earnings should then be re-pegged to $50 million, and the firm should be valued at the original $500 million in the initial public offer, not $400 million.

The underwriters respond that, yes, the board will be better. But, they ask, in whose interest will the board run the firm? With the supervisory board codetermined, the charged-up board will tilt more to labor when labor's and shareholders' interests conflict than would a purely shareholder-dominated board. Managers will be monitored more, but they will not necessarily be monitored in shareholders' interests. The enhanced board will create value, but some of that value will go to labor not stockholders. The underwriters conclude that the firm will indeed be worth $500 million, but $100 million of that value will go to labor. These numbers are not out-of-line with the current empirical work on the effect of the 1976 codetermination law, the one that expanded labor's representation from one-third of the supervisory boards of large firms to one-half. The data available show a ten to twenty percent effect on shareholder value.[14]

The family wants to keep that $100 million. They can re-visit whether they should sell out completely. They may decide to keep the firm private and re-examine whether they can find an heir who will run it. Or they may hire professional managers to run the firm, if they have not done so already. Or they may sell the firm, but sell it not to diffuse stockholders who will discount the price because they would fear agency costs, but to another dominant owner, who need not discount the price because he or she can overcome those costs. Such block sales are common in Germany.[15] To keep that $100 million difference, the family does *not* launch an IPO; hence there is one less public firm in Germany and one less family interested in seeing Germany developing a strong securities market.

Hence, German social democracy, institutionalized in corporate governance via codetermination, induces this firm to stay private, so as to avoid the costs to shareholders of enhanced labor voice inside the firm. Social democracy in the form of supervisory board codetermination, hence, mixes badly with the public firm.

2. Social democracy's effects without codetermination — Social democracy's pressure on the public firm persists even if we remove the formal institution of German supervisory board codetermination.

(*a) General effects: Favoring employees over shareholders* — Recall the basic agency costs to shareholders: unconstrained managers, unlike shareholders, prefer to expand their firms for more satisfaction, power, prestige, and pay. Managers want to avoid many profit-maximizing risks that would risk their careers. Managers prefer to use up capital in place rather

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[14] Felix R. FitzRoy & Kornelius Kraft, Economic Effects of Codetermination, 95 Scand. J. Econ. 365 (1993); [Gary Gorton & Frank A. Schmid. Corporate Finance, Control Rights, and Firm Performance: A Study of German Codetermination (University of Pennsylvania working paper, 1998);] Frank A. Schmid & Frank Seger, Arbeitnehmer-mitbestimmung, Allokation von Entscheidungsrechten und Shareholder Value, 5 Zeitschrift für Betriebswirtschaft 453 (1998); but see Theodor Baums & Bernd Frick, The Market Value of the Codetermined Firm, *in* Employees' Role in Corporate Governance 206 (Margaret Blair & Mark J. Roe, eds. 1999) (finding no impact); Bernd Frick, Gerhard Speckbacher & Paul Wentges, Arbeitnehmermitbestimmung und moderne Theories der Unternehmung, Zeitschrift für Betriebswirtschaft 745-63 (1998-V) (critiquing studies that showed codetermination as negatively affecting stock price).

[15] Franks & Mayer, supra note 3.

than to restructure a firm, because restructuring can be painful. And managers may be more willing to tolerate slack than would shareholders.

These basic agency costs are well understood. But less well discerned is that these managerial tendencies fit well with employees' goals, and that a second basic corporate governance problem—for employees and capital-providers—is the persistent tension between invested capital and current employees, a tension muted in the U.S., but not muted everywhere. Employees *also* are averse to risks to the firm, as their human capital is tied up in the firm and they are not fully diversified. Employees *also* prefer that the firm expand, not down-size, because expanding often yields them promotion opportunities while down-sizing risks leaving them unemployed.[16]

On a simple level, employees prefer higher wages, shareholders prefer lower wages (at the same level of productivity). Because wages are not precisely determined, managers hold some discretion in setting wages;[17] weakly monitored managers will not fight as strongly for shareholders as strongly-monitored managers.[18] Even in the U.S., slight differences in shareholder control of managers affect wage rates, with less-monitored managers, in states where anti-takeover laws are strong, conceding higher salaries to employees than where the laws are weak.[19] On a more complex level, American managers of firms in declining industries tended in the 1980's to use up their equity capital before shrinking their firms unless corporate

[16] And institutional creditors, who loom larger in European firms than in their American counterparts, prefer to avoid risk and to maintain stability. Incompletely diversified family stockholders, the last key player in large continental European firms, also prefer stability more strongly than diversified American public firm stockholders. The key risk-avoiding pieces all fit together in continental Europe. The fit here may not be accidental. European history may have created a craving for stability, to overcome an unstable past. Corporate institutions that facilitate that stability survived. An American analyst (such as myself) sees the lack of a key corporate structure as a failing, but social democracy may not only satisfy a European demand for stability but the sense of solidarity it yields its participants may increase social welfare.

[17] Lloyd Reynolds, The Structure of Labor Markets: Wages and Labor Mobility in Theory and Practice (1951); Richard Lester, A Range Theory of Wage Differentials, 5 Ind. & Labor Relations Rev. 483 (1952).

[18] Daron Acemoglu & Andrew Newman, The Labor Market and Corporate Structure, (June 1997) (MIT Dept. of Economics Working Paper No. 97-8).

[19] Marianne Bertrand & Sendhil Mullainathan, Is There Discretion in Wage Setting? A Test Using Takeover Legislation, 30 Rand. J. Econ. 535 (1999).

governance controls induced them not to use up equity first;[20] this is the strategy that incumbent employees would prefer.

In the U.S., much corporate governance has the effect, and often the intention, of breaking managers' preference for continuance, excessive risk reduction, and over-expansion, the goals employees also prefer. When these governance devices succeed, they align managers more closely with shareholders than they would otherwise be aligned. They reduce the overlap between managers' goals and employees' goals, and enhance the overlap between managers' goals and distant stockholders' goals. Managers become stockholders themselves and get stock options that are valuable if their firm's stock price rises. Managers see their results "posted" daily in liquid stock markets. Managers are monitored by outside directors, whose lawyers tell them that they, the directors, work primarily for shareholders.[21] Managers and directors are socialized in business school and at work to believe that shareholder wealth maximization is a valid norm, one that they should pursue.

(b) Direct effects: Softening change and raising agency costs — Social democracies favor incumbent employees. They act directly by insisting that firms not lay-off employees; managers not tied tightly to shareholders will resist such efforts only weakly (because they do not pay for going along, but take a great deal of heat for resisting the government). Such governments will also seek to stabilize employment in firms with dominant stockholders, but dominant stockholders, with their own money on the line, will resist the government's actions more vigorously.

(c) Indirect effects: Rigid labor markets as raising agency costs — Even when social democratic employment policies affect diffusely-held and closely-held firms equally, they will affect ownership structure. Social democratic policies often make it very hard to lay-off workers, even during economic adversity.[22] True, *when* the firm faces adversity and seeks to down-size, each ownership structure faces the same constraints. Hence, one

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[20] Cf. Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance and Takeovers, 76 Am. Econ. Rev. 659 (1986).

[21] In one well-known merger, directors asked their attorney, a leading merger advisor, to what extent they could consider other constituencies when evaluating offers. "A buck a share," the advisor is said to have replied.

[22] See Des réactions politiques et syndicales sévères, Le Monde, Sept. 11, 1999, at 16, quoting the leader of the governing French party: "It's unacceptable that a large firm can decide to reduce employment … simply to enhance shareholder profits."

might (mistakenly) conclude that social democracies will not affect the choice between ownership structures. But dominant stockholders would be more averse to expanding *ex ante* when labor markets are rigid than if employment rules were looser. Unconstrained managers often prefer to expand their firm, as is quite well-developed in the managerial literature. Since they gain from expansion, but do not always pay the price if expansion turns out to be unprofitable, they may well (unless constrained) expand, their firms may deteriorate more, and in anticipation of this risk, stock will diffuse into public markets less in social democracies than in more conservative nations.

Government policies wedge open the gap between shareholders and employees, by creating laws and a social climate that make it harder for managers to down-size when technology demands down-sizing or harder for managers to take risks with the enterprise when markets warrant it (from a shareholder perspective). They give employees more rights to resist change.[23] They construct nation-wide bargaining platforms that favor employees, platforms in which "coalition costs" among shareholders will be lower, and hence shareholders will be more successful, if shareholders act cohesively. They see managers and employees as allied, and opposed to distant institutional shareholders,[24] who, because they merely seek financial gain,

[23] Cf. Arnaud Lepartmentier, L'Allemagne industrielle de nouveau conquérante, Le Monde, Nov. 28, 1998, at 1, 17 (Gerhard Schröder, when minister of Lower Saxony—he is now the German prime minister—had a steel mill nationalized rather than see it taken over by a foreign firm, because he did not want a restructuring that would affect the German employees); Alain Faujas, Français, Allemands et Italiens n'attendent rien de bon des entreprises, Le Monde Economie, June 1, 1999, at IV ("60% [of the French] feel that government regulation and taxes handicap French firms, but [they applaud this result] as 51% also say the State must more severely control firms to prevent them from degrading social conditions"); id. (a majority in each of Germany, Italy, and France believe "the firms' interests and the people's interest are not the same," while in Britain a majority thought the contrary).

[24] From a book well-known in European business circles: "Is the firm a simple piece of merchandise …? Or is it … a community *in which the stockholders' power is balanced by managerial power, which is in turn … co-opted … by the employees …?*" Michel Albert, Capitalisme contre Capitalisme 19 (1991) (translated from the French) (emphasis added); cf. David Charny, Workers and Corporate Governance: The Role of Political Culture, *in* Employees Role in Corporate Governance 91 (Margaret Blair & Mark Roe, eds. 1999) (distinguishing labor/corporate governance regimes, as "hard," "soft," and "mixed").

must be constrained.[25] Managers, already disposed for their own reasons to expand unnecessarily, to go slow when re-vamping the firm, to avoid risk, and to refuse to down-size, feel pressured to slow down further and face social opprobrium if they move too quickly. Managers who excessively expanded their enterprises in a strong social democracy would especially burden their shareholders, as reversing a mistaken expansion is hard to accomplish in a social democracy.

Strong social democracies raise the pressures on managers to abandon their shareholders and side with employees to do what managers want to do all along: expand, avoid risk, and avoid rapid change.

Social democracies, in short, raise agency costs.

C. Social Democracies and Agency Costs: Shareholders' Control of Managers

Moreover, social democracies make the mechanisms that would control agency costs more difficult, or impossible. When the gap between managers and shareholders is small, some of the tools may not be worth their cost. Nations with lower agency costs may not need all of them. But as agency costs rise—as the gap between managers and shareholders widens—or as intense competition makes even a moderate gap harder to tolerate, the demand for gap-closing tools will rise. Social democracies not only widen the gap as we saw in the prior Section, but make the gap-closing tools—shareholder wealth maximization norms, transparent accounting, incentive compensation, and hostile takeovers and proxy fights—harder to employ.[26]

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[25] Frédéric Lemaître, Le succès de l'actionnariat salarié bouleverse le capitalisme français, Le Monde, Mar. 2, 1999, at 15, col. 1.

[26] The U.S. historically lacked some but not all of these tools, but its gap was smaller than elsewhere because American firms felt only weak social democratic pressures. In recent decades, intensified competition and technological change have called forth stronger tools than American shareholders previously needed. And, when American industries were less competitive, large firm oligopolies lost something from managerial agency costs, but gained oligopoly profits to spread around to shareholders, managers, and employees. See Mark J. Roe, From Antitrust to Corporate Governance?—The Corporation and the Law: 1959-1994, *in* The American Corporation Today 102, 105, 111-13 (Carl Kaysen ed., 1996); cf. Ravi Jagannathan & Shaker B. Srivivasn, Does Product Market Competition Reduce Agency Costs? (U. Minn. working paper, July 1999).

1. Shareholder wealth maximization — Consider first a soft control: a belief in shareholder wealth maximization. This norm, widespread in American business circles, surely affects what managers think about their tasks.[27] But it is not self-evident outside of American business circles that business be organized around a shareholder wealth maximization norm, a norm that does not inherently derive from even a utilitarian norm: why *shareholders'* wealth, when shareholders make up such a small and already-favored part of society?[28] One answer is that this is the distributional "price" for getting good capital allocation. Another is that shareholder wealth roughly proxies for total wealth and no other norm is, right now, plausible to implement in diffusely-owned firms: managers need, in this analysis, a measurable guide and *total* wealth maximization is too hard to measure and implement. But this "proxy" justification is theoretically contestable and widely disbelieved in social democracies. Managers there see more newscasts, read more articles, and have more conversations disparaging shareholder wealth maximization than their counter-parts see, read, and have in a non-social democracy. Political leaders will sympathize with employees more there than elsewhere. An American union officer involved in the Chrysler-Daimler merger said, "it is amazing to me that in Europe the corporations … feel that they have [an ethical] obligation to their employees … . Th[is] come[s] naturally in the European culture, while here in America we work hard to establish this and in a lot of instances have failed miserably."[29] American labor has tolerated a corporate focus on profitability more willingly than has labor abroad.

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[27] See, e.g., the famous essay by Milton Friedman, The Social Responsibility of Business Is to Increase its Profits, N.Y. Times Magazine, Sept. 13, 1970, at 33. Although aggressive when it appeared, in the U.S. Friedman's perspective is now mainstream in business circles and not unthinkable then (as it may be in some social democracies now). Cf. Andrew Graham, The UK 1979-95: Myths and Realities of Conservative Capitalism, *in* The Political Economy of Modern Capitalism—Mapping Convergence and Diversity 117, 119 (Colin Crouch & Wolfgang Streeck, eds. 1997) (cultural primacy of profit in Margaret Thatcher's Britain); Michael E. Porter, The microeconomic foundations of economic development, *in* World Economic Forum, The Global Competitiveness Report [1999], at 38, 42 ("In western Europe … the inability to place profitability as the central goal is … the greatest constraint to economic development.").

[28] Cf. Robert Kuttner, Soaring Stocks: Are Only the Rich Getting Richer? Bus. Wk., Apr. 22, 1996, at 28 (wealthiest 20% own 98% of American stocks).

[29] Timothy W. Ryback, The World of Business—The Man Who Swallowed Chrysler, The New Yorker, Nov. 16, 1998, at 80, 83.

Social atmosphere is important when managers have discretion, as they must have; the social pressures they feel will affect how they exercise that discretion. Weakly monitored public firm managers in social democracies will find it psychologically hard to work primarily for shareholders. They will believe themselves to be somewhat evil, or at least not wholly good, if they maximize shareholder value and tighten up the workplace.[30] Hence, they will do so only reluctantly, and sometimes not at all.

2. Transparent accounting — Policy-makers and academics in continental European nations complain that accounting there is not transparent enough. Distant shareholders cannot fully understand their firm, stock cannot be quickly priced accurately, and insiders with better information can make out like bandits via insider trading.

Opaque accounting could be due to technical failings, as it usually is seen to be. But the failures may be more than technical. Business owners in social democracies may *prefer* that employees *not* know how well the firm is doing, fearing that when profits are high employees will demand higher pay. They may accordingly *prefer* that the publicly available information be opaque. But when information is poor, the demand rises to have owners closer to, or inside, the enterprise, owners who can see through the smoke and monitor managers well. Hence, it's plausible that continental Europe's accounting owes its opacity (or the low demand to clear it up) partly to social democracy and not just to technical failure. If accounting were improved, the improvements would have two off-setting effects on distant stockholders in the social democracies: strengthening them against insiders, but weakening them vis-a-vis labor. Which effect would be stronger cannot be predicted *a priori*.[31]

3. Incentive compensation — Incentive compensation helps to align managers with shareholders. But stockholders need to oversee managers' compensation to prevent a complete disconnect between pay and performance; and, weak as this connection can be in the United States, making compensation details known to public stockholders better aligns pay

[30] This anti-shareholder sentiment is hardly absent in the United States. It ebbs and flows, stronger during the years of Ralph Nader's 1970's Campaign GM, say, and weaker during the Reagan 1980's, but surely it is much weaker in the U.S. than in continental Europe.

[31] I do not denigrate the possibility that players with informational advantages prefer to keep the firm opaque to others. Banks, if satisfied with the information they get, may not want to increase transparency and thereby lower the costs of the banks' financial competitors.

and performance than otherwise. But in social democracies making high compensation publicly known would exacerbate tensions with employees. (Surely that tension arises in the U.S., but because the U.S. is less of a social democracy—or not one at all—the resulting tension is not as strong.)

Continental firms can use incentive compensation. But it will work better for European shareholders if kept secret from employees (opaque accounting again) and offered by a controlling shareholder, who monitors what public markets do not see. It's not an accident that it's the French socialist government that seeks to make managerial compensation more transparent, and it's French owners who "fear that [more] information about individual salaries will induce more … social tensions."[32] In social democracies with greater employee tensions and demands, public knowledge of a specific firm's high managerial compensation would heighten employee demands, de-legitimize that firm's owners and managers, and, hence, raise the costs to shareholders of this means of controlling agency costs in the public firm. Compensation consultants' survey data show long-term incentive pay to be low in Europe (other than in Britain); indeed it's at zero for several nations.[33]

Firms know that heavy incentive stock options for managers will raise tensions with employees. When Daimler-Benz sought them, union officials opposed them, because they feared the firm's objectives would change and jobs would be lost. This led to a rare contested supervisory board vote, with labor voting against. The option plan, although passed, stayed small:

> The divided vote on Daimler-Benz's supervisory board show[ed] that there is no consensus in Germany about … shareholder value as it is widely understood in the US or the UK. … [E]ither the option element … will remain small and thus symbolic …; or, if … substantial, the relationship

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[32] Philippe Mabille, Stock-options: vers des prélèvements allégés et une transparence accrue, Les Echos, Dec. 9, 1998, at 2, col. 1; cf. Gail Edmondson, France: A CEO's Pay Shouldn't Be a Secret, Bus. Wk., Aug. 9, 1999, at 47 (Viénot corporate governance committee will not recommend disclosure of CEO pay); Les stock-options seraient moins imposées et plus "transparentes," Le Monde, Dec. 10, 1998, at 9, col. 5 (French socialist party seeks rules to have total managerial compensation publicly-known). I suspect the socialist government sought not to facilitate shareholder monitoring, but to expose high managerial salaries.

[33] Martin J. Conyon & Joachim Schwalbach, Corporate governance, executive pay and performance in Europe, *in* Executive Compensation and Shareholder Value13, 25 (Jennifer Carpenter & David Yermack, eds. 1999)

> between industry and trade unions may become more confrontational, especially when the same managers lay off thousands of employees.[34]

Moreover, governments in the social democracies are often hostile to stock options.[35] Governments of the left in France have been unhappy about a mechanism that would make the well-to-do better off,[36] and it's plausible that they also did not want a corporate tool that would bind senior managers to stockholders. Even when the technical tools for options are available, their visible use would exacerbate tensions inside the firm. In Germany and Sweden, stock "options aren't considered entirely ethical,"[37] presumably because managers there are expected to represent all of the firm's constituencies, and stock options would bind them tightly to one of them.[38]

4. Hostile takeovers and proxy contests — Hostile takeovers can control agency costs in public firms. The stock price of mismanaged firms will sag, and managers at other firms, or takeover entrepreneurs, will buy up the stock cheap, improve the target firms' operations, and thereby profit. While the debate in the 1980's in the United States was wide as to whether

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[34] Wolfgang Munchau, Moves towards share options for top managers are likely to provoke controversy, Fin. Times, Apr. 24, 1996, at 23.

[35] Virginie Malingre & Michel Noblecourt, Les députés PS veulent taxer davantage les stock-options, Le Monde, Oct. 15, 1999, at 8 (key players in governing party want to tax stock options more heavily); Laurent Mauduit, Le gouvernement diffère la réforme fiscale des stock-options, Le Monde, Jan. 9, 1999, at 7, col. 1 (left pulls reform to lower high taxes on stock options out of a "pro-innovation" package); Virginie Malingre, Le Sénat veut supprimer les charges sociales sur les stock options, Le Monde, Feb. 13, 1999, at 6, col. 1; cf. Christopher J. Mesnooh, Stock Options in the United States and France: A Comparative Regard, MTF—L'AGEFI, No. 102, Nov./Dec. 1998 (French stock options taxed unfavorably).

[36] Mabille, supra note 32, at 2, col. 2 ("the pill[, the subsequently-withdrawn proposal to facilitate stock options,] is not an easy one to swallow for the left, which is highly distrustful of a tool that they see as a means for managers to give themselves a super-bonus").

[37] Peter Goldstein, Compensation Packages for Executives Aren't All Alike—Base Pay Converges in Europe, but Bonuses and Stock Options Vary, Wall St. J. Europe, Dec. 22, 1998, at 4, cols. 4-5.

[38] See Graham Bowley, Hoechst launches stock option scheme, Fin. Times, Sept. 14, 1997, at 13 ("Only a handful of Germany's biggest companies have adopted share option schemes … because of strict German regulations on employee ownership."). The French socialist government in 1999 withdrew a plan to facilitate stock options, and in Germany "the business community is bracing for higher taxes on gains from exercised options under the new Socialist-led government." Goldstein, supra note 37, at 4, col. 5.

this was the primary cause and effect, surely it was one effect, and a shareholder-oriented takeover policy would cull out the extraneous causes and effects. In prior decades, intermittent proxy fights played a similar role.

Hostile takeovers have been notoriously harder in continental Europe than in the United States and Britain. True, there are fewer truly public firms, making the background rate necessarily low. But although a few hostile takeovers have been tried in Germany, they foundered due to the political pressure one would expect in a social democracy, as workers campaigned to block the takeovers and politicians sided with employees and against the capital owners.[39] In a major attempted takeover in the steel industry, the nominally *conservative* German chancellor said he was "deep[ly] concern[ed]" over it, asking the firms and players to "live up to their social responsibilities."[40] They substantially cut back their planned restructuring. As of 1999, "[n]o hostile takeover … has ever succeeded in Germany."[41] That may change soon in the year 2000, but the history is again clear.

Takeovers occur from time to time in France. But often Ministry-approval is usually necessary, sometimes as a formal requirement, sometimes as an informal understanding; and the Ministry has rarely approved a takeover without a social plan in place, one that had the offeror renouncing laying any employee off at the target for two or five years.[42] If a no-layoff policy is the

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[39] Michael Woodhead, A pyrrhic victory for Germany, Sunday Times (London), Mar. 30, 1997, § 3, at 7, col. 1 ("The foiling of Krupp's bid for Thyssen is a victory for the social consensus."); Steeled for battle, Fin. Times (London), Mar. 22, 1997, at 9 (mainstream German newspaper asks if executive seeking takeover wants to set Germany on fire). German politicians brokered a partial merger on terms favorable to incumbent employees. Greg Steinmetz & Matt Marshall, Krupp Suspends Hostile Bid for Thyssen, Wall St. J., Mar. 20, 1997, at A13 ("the steel merger is less attractive than a full merger. But the smaller merger is politically more acceptable …"); Richard Halstead, Steel is put to the sword, The Independent (London), Mar. 23, 1997, at 3 ("The combined forces of federal economics minister Guenter Rexrodt and Johannes Rau, premier of North Rhein Westphalia, Germany's biggest state, bounced Germany's virtually sole corporate raider into 'negotiations' with Thyssen.").

[40] William R. Emmons & Frank A. Schmid, Universal Banking, Control Rights, and Corporate Finance in Germany, Fed. Res. Bank of St. Louis Rev., July/Aug. 1998, at 19, 22.

[41] William Boston, Hostile Deal Could Breach German Resistance, Wall St. J., Nov. 17, 1999, at A17. Vodaphone's probable takeover of Mannesmann will change this.

[42] Such approval is mandatory for takeovers that foreign firms initiate, and typically but less formally required for takeovers that domestic firms initiate. Cf. Banque: le coup de poker de la BNP, Le Monde, Mar. 11, 1999, at 1, col. 1 (in huge hostile offer to build the world's largest bank, the offeror's CEO immediately promises not to lay off anyone in

price for a takeover, as it usually has been, an offeror will see a takeover as less valuable, because restructuring will be harder (as restructurings often lead to layoffs) and because employees' motivation after the takeover might change for the worse.[43] The Minister of Finance has been suspicious of high-priced takeovers, because, he said when deterring one such high-price offer in 1998, the "high price means the buyer would have to look immediately at higher profits to pay for the acquisition, which could be negative … for jobs."[44] Until 1999 the state often decided takeover results and, even when it withdrew from overall control, it continued to seek to avoid takeovers that would yield "a social massacre" with "massive layoff[s]."[45] Only recently, as governments in Europe have moved toward the right economically, have hostile offers appeared and, even so, they are appearing at a rate thus far much lower than that prevailing in the U.S.

These forces are present in the United States. Labor unions campaigned for anti-takeover laws, and labor can influence politicians' votes.[46] But labor unions and labor-oriented political parties are not as

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France).

[43] Cf. Edmund L. Andrews, A French Concoction, N.Y. Times, Sept. 21, 1999, at C1, col. 2 (after Totalfina bought Elf Acquitaine, "[m]ost experts assume [Totalfina] will have to shut down at least one refinery in France and perhaps others around Europe. But that will ignite a storm of protest, and Elf has already been plagued with strikes this year."). A J.P. Morgan oil analyst concluded that "the potential savings are well above two billion euros … [but the] difficulty is knowing how long it would take to deliver those savings." Id.

[44] Alan Katz, Shareholders Gain Voice in France, But Socialist Tradition Talks Back, Wall St. J., Feb. 13, 1998, at B7D. A high price might indicate high inefficiencies, perhaps including redundancies in the work-force. In contrast, consider what an American analyst considers to be the critical social issues to negotiate in a takeover:

> A critical part of the negotiation of large merger transactions is the resolution of such social issues as the location of the headquarters for the combined entity and the determination of who will lead the "new" company, [a Goldman, Sachs managing director] explained.

Eileen J. Williams, Focus: Mergers and Consolidations, Corp. Counsel Weekly, Mar. 24, 1999, at 8.

[45] Martine Orange, La fin de l'exception française?, Le Monde, Mar. 30, 1999, at 19.

[46] Management and Labor Join Forces to Stiff-Arm Raiders in Pennsylvania, 7 Corporate Control Alert 12, 8 (Jan. 1990); Leslie Wayne, Pennsylvania Lends Force to Antitakeover Trend, N.Y. Times, Apr. 19, 1990, A1, col. 3; Samuel Szewczyk & George

powerful in the U.S. as they are in continental nations; many American politicians ignore them and survive; and American corporate law is made in contexts (such as in the Delaware legislature and courts) where labor's influence is indirect and weak. This weakness helps to explain why constituency laws, which allow boards to consider players other than shareholders, have hardly affected the firm. One might cynically see these laws as made by and for managers, who wanted freedom to oppose hostile takeovers and, once they had it, offered employees little more. The underlying American political reality did not give managers any further reason to tie themselves to employees on a day-to-day basis.

Constituency statutes in theory unlinked managers from unswerving loyalty to shareholders. Managers can take employees, communities, and the like into account in their decisions. (Through the business judgement rule perhaps American *law* never linked managers tightly to shareholders.) But other powerful means— compensation, shareholder wealth norms, takeovers, transparent securities markets, etc.—make managers sufficiently loyal to shareholders to keep agency costs low enough. Because the underlying American social reality does not continually press managers to side with employees, constituency statutes' long-run effects have been limited.

* * *

Hence, agency costs in social democracies will be higher than elsewhere. The social and psychological atmosphere will induce unrestrained managers to coalesce with employees more than otherwise, and incentives and techniques that would otherwise control and align managers with public shareholders will be weak and used only sporadically. The Berle-Means firm's higher relative cost to shareholders in social democracies will reduce its incidence, and shareholders will seek another means of control, namely, direct control via block ownership.

II. The Data

A. Regressing Ownership Concentration on Politics

We now have a simple, powerful theory, that social democracies open up a gap between managers and distant stockholders, and that they impede firms from developing the tools that would close up that gap. What

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Tsetsekos, State Intervention in the Market for Corporate Control—The Case of Pennsylvania Senate Bill 1310, 31 J. Fin. Econ. 3 (1992).

correlations should flow from the theory, and do the data confirm or contradict the predictions? We could compare political orientation with ownership structure, expecting that left nations would correlate with lower diffuse ownership and right nations with higher diffuse ownership.

So they do. Table I lists nations' politics from most left to most right, based on a poll of political scientists around the world.[47] Table II lists the nations' incidence of block ownership in their larger firms; those with the highest score have the fewest firms with concentrated ownership and, hence, their largest firms have the most diffuse ownership.[48] Table III shows the correlations' statistical significance, which is high.

[47] The political data is from Thomas R. Cusack, Partisan politics and public finance: Changes in public spending in the industrialized democracies, 1955-1989, 91 Public Choice 375, 383-84 (1997), which arrays a survey from Francis G. Castles & Peter Mair, Left-right political scales: Some 'expert' judgements, 12 European J. Pol. Sci. 73 (1984).

[48] The ownership data and judgement are from La Porta et al. supra note 6, who sought to show something else: that failure to protect minority stockholders is the primary determinant of a nation's inability to get diffusely-held firms.

B. Tables and Correlations

Table I
Political Placement of Richest Nations' Governments in 1980s

Sweden	2.22
Austria	2.37
Australia	2.50
Norway	2.63
Finland	2.68
Italy	2.76
France	2.83
Netherlands	3.14
Belgium	3.16
Denmark	3.40
Switzerland	3.43
Canada	3.67
Germany	3.82
United States	3.92
Japan	4.00
United Kingdom	4.00

Table II
Percentage of Widely-Held Firms Among 20 Largest Public Firms

Austria	.05
Belgium	.05
Italy	.20
Norway	.25
Sweden	.25
Netherlands	.30
Finland	.35
Denmark	.40
Germany	.50
Canada	.60
Switzerland	.60
France	.60
Australia	.65
United States	.80
Japan	.90
United Kingdom	1.00

Table III
Regressing Diffusion on Politics

	Regression coefficient (t-statistic)	Adjusted R-squared
Index of diffusion v. 1980-1991 political index (Table II v. Table I)	0.33 (3.66*)	0.86
Index of diffusion v. Four decade political index (four-decade index available from author)	0.45 (5.23**)	0.91

* Significant at .005 level (less than 1 chance in 200 that random).
** Significant at .0005 level (less than 1 chance in 2000 that random).

C. Discussion of Data

Again, these results are statistically significant; the R-squared value suggests that political orientation explains 45% of the variation.[49] The reader need not be reminded that correlation need not imply causation; the facts here though comport with the theory that social democracies drive a wedge between shareholders and managers, and thereby raise agency costs.

One should be cautious in interpreting these statistical results. True, they are strikingly strong in that the indices are only partly tuned to the political hypothesis I've set out here. But first, the ownership index does not include privately-held firms that have never gone public. European accounts say these are many, but systematic, comparable data for these nations is unavailable. (It's not surprising, based on the political thesis here, that such financial data for the strongest social democracies is not easy to uncover; some owners keep their firms private to keep their profile low.) The twenty largest U.S. firms are nearly all public firms; the twenty largest firms in each European country may include several fully private firms. If so, better data here should strengthen the political hypothesis.[50]

Second, the ownership index uses each nation's twenty largest firms. Perhaps there is a size beyond which *only* public firms can exist, because, for example, private parties lack the wealth to take on a major ownership interest. If only the U.S. economy has historically been big enough to generate twenty

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[49] The four-decade political average correlates more strongly with ownership structure. It ought though to be weaker since it matches a forty-year political index with a single moment's concentration ratios. Perhaps a better longitudinal look would correlate concentration in each decade with the political index in each decade. On the other hand, political coalitions come and go; corporate structures are the result of long-term expectations of governmental orientation.

[50] The financial researchers building the concentration index classified government-owned blocks as if they were privately-owned blocks. But publicly-owned blocks do not at first reflect owners deciding that concentration will promote shareholder wealth better than would dispersion. Still, governments often take blocks if social pressures deter private players from investing, and the firm can continue, or arise, only if the government invests. Thus linkage is plausible. Government blocks for purposes of a competing theory—that poor legal protection of minority shareholders induces blockholding—is questionable, as governmental motives in keeping blocks are unlikely to link directly to minority shareholder protection, although it is true that the government might invest if capital markets do not fund very large firms.

of these very big firms, then size not politics might be the underlying determinant. But we can correct for size, by using the twenty largest firms in each economy worth just over $500 million. We do so in the Appendix and find that the powerful political correlation persists. Size is not the primary determinant.

Third, the political indices are based on the averaging of a poll of political scientists who rated political parties from left to right on a numerical scale;[51] characteristics beyond economic issues, such as nuclear disarmament, race, and other non-economic issues surely figured into the judgment. These will only roughly correlate with the economic left-right scale that would be the best foundation for this study. For example, the French conservative parties were consistently rated as more conservative than the American Democratic Party,[52] although on economic issues I see them as to the left of the Democratic Party. Despite the "noise," politics correlates with ownership concentration.

We can reduce this third problem by looking at another measure of the strength of a nation's social democracy, the extent it compresses incomes and reduces inequality. A standard measure of income inequality, the Gini coefficient, can relate the richest nations' relative tolerance for inequality and, hence, the relative strength of social democracy. Tables X and XI in the Appendix compare income inequality to diffuse ownership: nations that refuse to tolerate much inequality have fewer diffusely-owned public firms and much more concentrated ownership.

But while the correlations are strong, a sample of the world's sixteen richest nations isn't big enough to readily test out the comparative power of *other* explanations, but we cannot extend the sample, because the poorer nations are not economically "ripe" for large public firms. So, the nature of legal systems (common law vs. civil law) has been advanced as helping to explain ownership concentration, with French and German systems protecting minority stockholders badly.[53] We would want to test out the comparative explanatory power of politics and law, by, say, finding those nations that protect minority stockholders well, *but* are strong social democracies, and then see how many public firms there are there. If such nations regularly had diffuse ownership, the legal theory would seem stronger; but if they had

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[51] Castles & Mair, supra note 47.

[52] Id. at 78, 83.

[53] La Porta et al., supra note 6.

concentrated ownership, the political explanation would seem to trump the law-based one. Sweden fits this category: good law, strong social democracy, few public firms. If this result were generalized, it would support the political thesis over a legal thesis, but there aren't enough such examples, one way or the other, to generalize.

Thus the correlations here make for, in a lawyer's rhetoric, a prima facie case that political placement affects structure, but doesn't give us a clear sense how heavily to weight the political explanation against the prevailing more standard ones. Hence, the discussion of competing theories must be qualitative, not quantitative, and I offer that discussion in Part IV.A., by looking, however briefly, behind the numbers at several of the nations. Such a qualitative, nation-by-nation look tends to buttress the political theory.

D. Qualitative Discussion of Selected Nations

1. France — France displays a medium number of "widely-held" firms, despite that commentators see it as an exemplar of family- and state-ownership.[54] This result arises because French government policy sought to structure major French firms with a "hard core"—in French, *noyau dur*—of national ownership, but typically did not seek to have 20% of the stock (the cutoff for blocks in Table II) owned by a single French firm. A 10% cutoff drops France's proportion of widely-held firms dramatically, down to only one in three, while it hardly changes that for the U.S., Britain, and others.[55] And when one controls for size by comparing only "medium-sized" firms— those with a market capitalization of at least $500 million—France has *no* widely-held firms, while 90% of the similarly-sized American firms (and 60% of the British) are widely-held.[56] Moreover, the recent privatizations in France led workers, on average, to own 8% of those firms' stock and have three of their

[54] Jonathan P. Charkham, Keeping Good Company: A Study of Corporate Governance in Five Countries 125 (1994); James A. Fanto, The Transformation of French Corporate Governance and United States Institutional Investors, 21 Brooklyn J. Int'l L. 1, 36 (1995); Windolf, supra note 4.

[55] Appendix, Table VIII; La Porta et al., supra note 6 (Table II, Panel B).

[56] Appendix, Table VII; La Porta et al., supra note 6 (Table III, Panel A, 20% cutoff, first ten firms with a market capitalization exceeding $500 million).

board seats.[57] In the Appendix are results from regressing both the "size-corrected" data and the "10%-cutoff" data. The correlations persist.

Qualitative French business histories are consistent with the social democracy thesis. Consider Charles Kindleberger's perhaps hyperbolic description in a standard work of European economic history:

> [The French family firm] is said to have sinned against economic efficiency … by failing … to extend into new markets … . Public sale of stock was avoided. … Recruiting was undertaken from within the family, except for faithful retainers who assisted the firm against the revolutionary working force.[58]

Profitable firms that seek to down-size are excoriated in the press by political leaders, with political threats made to deny them discretionary government benefits if they persist.[59] Nor does the French corporate code demand shareholder wealth maximization, and indeed it commands directors to run the firm in the general social interest.[60] Modern French managers have been socialized in two elite schools—two small state schools, l'Ecole Nationale d'Administration and l'Ecole Polytechnique, account for half of the managers and directors of France's leading firms[61]—to think more of national progress than of shareholder profit maximization.[62]

2. Germany — Germany's formal board structure strongly illustrates the "social democracy" effect, as we saw in Part II. German boards for large firms *must* have half of the directors from labor. This codetermination affects boardrooms. Meetings are infrequent, the information background is weak, and the meetings are quite formal; codetermination makes it hard for

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[57] Michel Boyer, The Transformation of Corporate Governance in France and Germany, at 41 (working paper, 1999).

[58] Charles P. Kindleberger, Economic Growth in France and Britain 115 (1960).

[59] Michelin, Le Monde, Sept. 23, 1999; [cite one when the firm back down.]

[60] James A. Fanto, The Role of Corporate Law in French Corporate Governance, 31 Corn. Int'l L.J. 31, 47, 88-89 (1988).

[61] Cf. Michel Bauer, Administrateurs et Dirigeants du CAC 40 (Report of CNRS Observatoire des Dirigeants, Sept. 1997).

[62] Cf. François Hollande, "Pour une extension des stock-options à l'ensemble du personnel," Le Monde, Oct. 7, 1999, at 6 (leader of France's governing socialist party says that "although our goal is not to socialize the means of production, one can neither leave the private sector without rules … nor allow stockholders alone to decide, without any input from employees, what to do solely due to shareholders' purely financial interests").

shareholders and managers to charge up the boardrooms with frequent, substantive, well-informed meetings, because to do so would enhance labor's voice and authority inside the firm. Managers and shareholders prefer not to further empower labor, so they weaken (or fail to strengthen) the boardroom.

Shareholders control managers otherwise. Dominant blockholders meet managers informally outside of the boardroom. Were ownership diffuse, shareholders would lose this means of monitoring managers, and shareholder value would presumably decline. With the board co-determined, shareholders could find the alternative of a more powerful boardroom unattractive: if they charged up the boardroom to better monitor managers, they'd make labor more powerful. The trade-off for shareholders—better monitoring of managers versus more powerful labor influence—might be tough to make; shareholding might therefore remain concentrated so that shareholders can avoid making the trade-off.[63]

This trade-off helps to explain the resistence in Germany to changing corporate and securities laws, accounting practice, and other institutions to better support diffuse ownership. Germany has had little problem in writing and passing good laws in other areas, or in building effective bureaucracies. True, public choice pressures could explain the result—banks prefer not to see good securities markets develop and family owners want their perquisites to persist. But public choice resistence can sometimes be overcome, and it's plausible that when it isn't, it's because countervailing pressures for reform do not come from shareholders, managers, and policy-makers. The countervailing pressures might not come because these players cannot profit from going public in Germany's social democracy, with Germany's boardroom structure.

3. Italy — Italy has many small family-owned firms and few public firms. A simple legal theory, one based solely on poor minority stockholder protection, is plausible for Italy, which is reputed to have a slow, inefficient, and sometimes corrupt court system. Indeed, the direction in the statistics supports the idea that another factor beyond politics is at play in Italy: Its firms' are even more diffusely owned than political placement would predict. But Italian players say that the commercial courts in the Milan area (Italy's industrial capital) are fine, and not really any worse than those in other leading nations. Weak corporate law though may be only part of the story even in

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[63] Mark J. Roe, German Codetermination and German Securities Markets, 1998 Col. Bus. L. Rev. 167.

Italy. Players dissatisfied with basic corporate law have not been unable to use contract to give themselves the private law rules that they want.[64] Economic-based social conflict has been historically high, labor-influenced political parties powerful, and a communist party that for several decades was supported by a quarter of the Italian electorate. Italian governments have fostered small closely-held businesses, because they thought employees would identify with owners in small firms, but oppose them, especially distant owners, in large firms. Large firms provoked more social tension than smaller closely-held ones.[65]

4. Japan — Japan's place in both the political and the ownership indices demands comment. The political scientists classified Japan as farther to the right than one might think, and the finance economists classified it as having a high level of diffuse ownership, despite that it is usually thought of as an exemplar of bank influence and ownership.

I have not adjusted the indices, taking them as I found them in the political science and finance literature. But qualitative judgements might well have led us to place Japan differently in each index. The governing political party has been conservative in name, but the public policies have been in many ways social democratic, although with a flavor differing from Europe's. Lifetime employment is a key institution, one developed to support social peace.[66] It in some ways makes Japan "more" socially democratic than the European social democracies.

Viewing Japanese ownership as diffuse is also questionable, but understandable when one sees how the indices were constructed. A firm was classified as concentrated if the largest shareholder owned 20% or more

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[64] Minority stockholders in Mediaset, Silvio Berlusconi's principal corporate vehicle—Berlusconi is the former prime minister and has a wheeler-dealer reputation—insisted on a corporate charter term super-majority board approval for any related-party transaction. (They expected board representation and, hence, veto power. Board approval for such transactions is not required under Italian corporate law, but contract could fill the gap.) I develop this contractual alternative in Part IV.A.3.

[65] Linda Weiss, Creating Capitalism: The State and Small Business Since 1945, at 104-05, 127-37 (1988).

[66] Ronald J. Gilson & Mark J. Roe, Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance, 99 Colum. L. Rev. 508 (1999).

of the firm's stock.[67] Few firms in Japan have this level of concentrated ownership. But in Japan's main bank system the leading industrial firms' largest four or five owners each own 4.9% of the firm's stock. If we cumulated the bankers' stock because the banks are said to defer to the main bank during corporate crises,[68] *all* of Japan's large firms would have concentrated ownership. Hence, if we qualitatively adjusted both the political side and the concentration side, lifetime employment and the main bank system would push Japan up on both indices. The correlation between politics and ownership structure would persist.[69]

5. Sweden. The world's first democratically-elected socialist government took power in Sweden in 1920.[70] It has been for quite some time the paradigm of the social welfare state, with cradle-to-grave social coverage.

Sweden presents variants of the political theory here. First, Sweden is reputed to have good corporate law in protected minority stockholders. That is, a leading explanation for why concentrated ownership persists is that if minority stockholder protection is poor, outsiders will buy stock only reluctantly, or only at a steep discount. Their reluctance translates into heavy ownership concentration and few public firms. But by conventional measures Swedish institutions protect minority stockholders well: The premium for voting stock, a measure of the value of control (and the opportunity to divert value into the controllers' pockets) is low, approaching that prevailing in the United States, at about 7%.[71] Outsiders could buy without gross fear of

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[67] La Porta et al., supra note 6, at __. In addition, institutions that are themselves diffusely owned were made transparent in the ownership index, so even a 20% shareholder that was a diffusely-owned bank made the firm a diffusely-owned firm.

[68] Masahiko Aoki, Towards an Economic Model of the Japanese Firm, 28 J. Econ. Lit. 1, 25-26 (1990).

[69] Note that the goals of a shareholder-creditor—the typical large Japanese shareholder—are not the shareholder wealth maximization goals of a pure, diversified shareholder, but correspond more closely to the goals of a lifetime employee; ownership fits with employment.

[70] See Przeworski, supra note 2, at 835.

[71] See [Luigi Zingales, The Value of the Voting Right: A Study of the Milan Stock Exchange Experience, 7 Rev. Fin. Stud. 125, 146-47 (1994) (discussing and citing sources on the value of the voting right in Sweden);] cf. Clas Bergström & Kristian Rydqvuist, Ownership of Equity in Dual-Class Firms, 14 J. Banking & Fin. 255, 267 (1990) ("data do not support the argument that dual classes are used [in Sweden] for wealth expropriation by holding control with little equity"); Clas Bergström & Kristian Rydqvist, The Determinants of Corporate

expropriation from insiders; and insiders could sell and diversify without taking a gross discount. Yet they don't.

Second, closely related to the legal theory is a theory based on trust. In mistrustful cultures, outsiders will greatly fear the depredations of insiders. But if trust is high and insiders will no more steal from outside stockholders than would citizens steal an unlocked bicycle, outsiders will entrust their investments to insiders. Sweden is a high trust society. Yet ownership remains concentrated, despite the high level of trust. Outsiders feel protected, but public securities markets are poorly developed.

Third, Swedish ownership has a high disjunction between cash flow rights and control rights. That is, the controlling family, often the Wallenberg family, gets [5]% of the company's profits, but controls, say, 51% of the company's votes. It does so by building ownership pyramids (by which it owns 51% of the "top" holding company, which in turn owns 51% of an intermediate company, which in turn owns 51% of other intermediate companies, until finally a lower-level company owns 51% of the operating company) or by using dual-class common stock (in which one class of stock gets 10 votes per share and another 1 vote per share).

Complex and intricate theories have arisen to explain the use of pyramids, dual-class structures, and non-voting stock. The most sophisticated rely on the owner seeking to protect the rents it gets from controlling the firm. That is, the controller is reluctant to leave control "up for grabs" because if the controller dips below 51% control of the operating company, an outsider could grab a majority and then reap the benefits of control.[72] The theory is

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Ownership—An Empirical Study on Swedish Data, 14 J. Banking & Fin. 237 (" the value of control does not derive from the possibility to expropriate the fringe of minority shareholders … [but] has to be motivated by some other economic motives"); Martin Holmén & Peter Högfeldt, Corporate Control and Security Design in Initial Public Offerings 38, 39 (Stockholm School of Economics working paper, Dec. 15, 1999) ("Outside shareholders do not refrain f[ro]m investing on the Stockholm Stock Exchange since 55% of the Swedish population own shares … and 33% of outstanding shares are owned by foreign investors… . [T]he ratio of the stock market capitalization held by minority shareholders in relation to GDP … is 0.51 for Sweden compared to 0.58 for the U.S. … . Thus, it is not likely that weak investor protection has hampered financial market development in Sweden … .").

[72] See [Lucian Arye Bebchuk, A Theory of the Choice Between Concentrated and Dispersed Ownership of Corporate Shares and Votes (Harv. Law & Econ. Working Paper, Oct. 1998); Lucian Arye Bebchuk, A Rent Protection Theory (working paper, 1999)]; [Lucian Bebchuk, Reinier Kraakman & George Triantis, Pyramids] (working paper, 1999); cf. La Porta

plausible. However, in its current stark form, it cannot explain the Swedish situation well, or at all, because Sweden is said to protect minority stockholders well. Hence, in Sweden, little of value would be left up for grabs by controlling shareholders who exited and diversified.

Adding employees and social democratic pressures back into the Swedish equation lets us explain the Swedish ownership concentration. Social democracy affects ownership in two ways here. One, the concentrated owner has stronger incentives than the Berle-Means managers to avoid giving up too much in shareholder value to social pressures. Although an owner whose 51% in control rights corresponded to equal cash flow rights would have even greater incentives to retain shareholder value, the issue here is one of relative strength. The pyramid, dual-class, or non-voting structure is less than ideal in providing incentives, but it still motivates a focused owner to deflect some social pressures: (a) A lot of the controller's wealth is still on the line, and (b) the structure preserves the controller's authority even while cash flow rights decline.

Moreover, if the concentrated owner is progressive, has a social conscience, and is not a thirsty shareholder-wealth-maximizer, then the political authorities and voters may prefer the incumbent over someone else who might grab control. That is, the authorities may prefer to avoid government ownership for its well-known inefficiencies, but not want the crass, cold market as the alternative. If the Swedish incumbents, such as the Wallenbergs, are "soft" players, who can cooperate with a social democratic ethos, then it may well be the social democratic forces who want to stop control from going "up for grabs." If control were "up for grabs," an American-style shareholder-wealth-maximizer might grab control, tighten the workplace, and undermine the social democratic program.[73]

Rents are to be protected, but they're not the rents from control (because the evidence is that value diversions in Sweden are low), but the *political* rents that a social democracy produces for the firm's employees and political players.

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et al., supra note 6.

[73] Cf. Almar Latour & Greg Steinmetz, Swedish Giant: Barnevik Set About Task of Preserving Wallenberg Empire, Wall St.J., May 18, 1998, at A1 (Wallenbergs resist outside shareholders' wealth maximization goals as "not [necessarily] serving society's best interests").

Two, social democracies level wealth and income. While they raise the "incentive" to focus control, they constrict the "supply" of rich people with the wealth to own very large industrial companies. *When technology and scale economies demand very large industrial firms, and when social democratic pressures demand focused ownership but reduce the number of wealthy people, then tools to yield control without vast wealth will be demanded.* Pyramids, dual-class structures, and non-voting stock are the typical such tools. Sweden, like several of the other social democracies, has them.

6. United Kingdom — The United Kingdom would seem the hardest case for the political theory here, in that by reputation Britain has had a deep securities market for quite some time, but has been on both sides of the fence politically, having been a strong social democracy for a good part of this century, and having been one of the planet's economically most conservative nations since 1979.

The U.K. also seems to fit badly with a law-driven theory. That is, a potential competing theory (we will synthesize the law-driven and the political theories shortly) is that law protecting minority stockholders is the driving force behind securities markets. British common law judges are said to have protected minority stockholders well. Yet, leading business historians, such as Alfred Chandler say flatly that the largest British firms were family-dominated as late as World War II, and family influence and control persisted well after then as well.[74] (Chandler blames family control for Britain's mediocre industrial performance in the 20th century.) This would at first seem consistent with the political theory and not with a legal theory. That is, if law

[74] Alfred P. Chandler, Scale and Scope 242 (1990); Alfred D. Chandler, Jr. & Herman Daems, Introduction, *in* Managerial Hierarchies—Comparative Perspectives on the Rise of the Modern Industrial Enterprise 6 (Alfred D. Chandler, Jr. & Herman Daems, eds., 1980) ("Until World War II, the British economy was for the most part an example of family capitalism."); Leslie Hannah, Visible and Invisible Hands in Great Britain, *in* id. at 41, 53 ("The separation of ownership and control … had not progressed far enough to displace founding or family directors from company boards[;] … 119 [out of the 200 largest firms in Britain], or 59.5 percent, [had founding or family directors] in 1948"); cf. Leslie Hannah, Mergers, Cartels and Concentration: Legal Factors in the U.S. and European Experience, *in* Norbert Horn & Jürgen Kocka, Law and the Formation of the Big Enterprises in the 19th and Early 20th Centuries 396 (1979) ("In the period before 1914 … it seems that the United States and Germany led the industrial world in introducing large-scale corporate organisation, whereas Britain retained a stronger inherited structure of family enterprise … .").

protected the minority stockholders, why didn't the families sell out and diversify quickly (as they do now[75])? Many of these families were still in place in the 1970s. ("[T]he managerial revolution heralded by Berle and Means in 1932 has probably not yet happened [here], … [where] over 55% of the largest 250 UK industrial companies [are] under owner control" said one authority in 1980, and, not anticipating the results in the subsequent two decades: "most [British] firms are unlikely ever to become controlled by their own professional managers".[76]) But within a few years of this 1980 pronouncement most families were in fact gone from the largest firms by the mid-1980s[77]; Britain's revolution from the right in 1979 made, on the theory presented here, the fully public, diffusely-owned firm a more viable entity.

Yet, Britain by many measures had deeper securities markets and more public firms than much of the rest of the world, *earlier in this century* although families held on to blocks and managerial positions until quite late in the 20th century. To explain this pattern, a synthesis of the minority-protection theory and the political theory works well. That is, British institutions protected minority stockholders, so that family owners could sell much stock even in the early 20th century without too severe a discount. Yet during that time, class conflict was deep, widespread, and severe.[78] The potential for high agency costs in the managerial firm was there and, hence, the family owners had reason to retain concentrated ownership. This hybrid theory seems to explain the British facts: a) a long history of firms going public, b) family retention of control in many public firms until well after World War II (when good law arguably protected the minority stockholders and politics made concentration desirable for shareholders), and c) a sell-off by the family owners in the late 1970s and in the 1980s (when the lurch to the right made diffuse ownership more stable).

[75] See [Michael J. Brennan & Julian Franks, Underpricing, Ownership and Control in Initial Public Offerings of Equity Securities in the UK, 45 J. Fin. Econ. 391 (1997) (family gone within [six] years after IPO in [1980s])].

[76] Arthur Francis, Families Firms and Financial Capital: The Development of UK Industrial Firms with Particular Reference to Their Ownership and Control, 14 Brit. J. Sociology 29 (1980); [cf. Steven Nyman & Aubrey Silberstron, The Ownership and Control of Industry, 30, Oxford Econ. Papers 1, 74-103 (1978).]

[77] [John Scott, Corporate Control and Corporate Rule: Britain in an International Perspective, 41 Brit. J. Sociology 351 (1990).]

[78] [John Scott, Corporations, Classes and Capitalism (2d ed. 1985); additional citations.]

This political interaction with ownership structure helps to explain Chandler's conundrum: if the British families held onto control, and ran many firms into the ground as he argues, why did they do so? Many attribute cultural explanations. But perhaps more was at work. I.e., perhaps family owners ran the firms badly, but when class conflict was rife, perhaps the alternative to family control was *worse* for owners.

7. United States — Why has the United States had fewer social conflicts of the type that would debilitate the public firm? The reasons why it has had less conflict, and hence more diffuse ownership, correspond to the reasons why a strong socialist movement did not arise in the United States.

Mobility, both geographic and economic, has been high, or at least the average person has believed it high.[79] Dissatisfied people have blamed their local circumstances (which they thought they could change, by heading out West or by getting another job) more than their class position. Hence, class conflict was less likely. And incipient conflicts were violently suppressed.[80]

The U.S. has also had a long and deep anti-government bias, so citizens have not looked as longingly to government to resolve problems as Europeans did. Economic conflict was not absent in the U.S., but manifested itself differently than in Europe, often leading politicians to break up concentrations of economic power, a result that further propelled the public firm, because there were fewer financial institutions that could build up large American firms at the end of the 19th century than there otherwise would have been.[81]

In the 19th century, America systematically destroyed strong financial institutions: American voters historically tended to be intolerant of big government *and* of big private finance. This fragmenting of finance may also have later diluted other social conflict, *by removing the visible targets of a strong social democracy movement*; and, with the visible targets gone, norms like shareholder-wealth-maximization flourished more easily than they otherwise would have. (Similarly, destroying family control in continental

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[79] Frederick Jackson Turner, The Frontier in American History (1920).

[80] See, e.g., John R. Commons, Is Class Conflict in America Growing and Is it Inevitable?, 13 Am. J. Soc. 756 (1908), *reprinted in* III Classics in Institutional Economics 112, 120 (Malcolm Rutherford & Warren J. Samuels, eds., 1997).

[81] Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (1994).

Europe could reduce subsequent social conflict sufficiently so that agency control institutions could emerge in the newly-created public firms.) Political packages might be complementary: American politics can tolerate pro-shareholder institutions, if the typical shareholder is CalPERS, not J.P. Morgan. European politics can tolerate large, influential stockholders, banks and families, as long as it also stabilizes employment and circumscribes the range of actions of the stockholders, bankers and the family owners.

Moreover, ethnic conflict in the U.S. has been deep, at times vicious. For some of the social conflict that would affect the Berle-Means firm to express itself in the political arena, employees would have had to have acted together or politicians would have had to appeal to all employees to elect them to enact a common program.[82] But if ethnic divisions—principally based on race—made it historically hard for American politicians to make an economic appeal across racial lines, then the kinds of conflicts that increased agency costs in public firms on the European continent became rarer in the U.S.[83]

8. Extending the sample? — One could extend the "sample" to include more nations outside of western Europe, developed Asia, and North America, adding, say, Thailand, Malaysia, Nigeria, and Argentina. But extension would reveal little, because too many of these nations have not yet arrived economically at the point where large firms are demanded. And, many lack the basic institutions needed for a very advanced economy, such as a capacity to enforce contract effectively. More telling is to look at those nations that have already developed many of the needed institutions, and have a high demand for large economic units, but for which politics in some of them makes some institutions function poorly or not worth building.

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[82] See, e.g., Commons, supra note 80, at 118-19; John R. Commons, History of Labor in the United States—1896-1932 (1935), *reprinted in* III Classics in Institutional Economics 438, 455 (Malcolm Rutherford & Warren J. Samuels, eds., 1997).

[83] Cf. E.E. Schattschneider, The semi-sovereign people: a realist's view of democracy in America (1960) (politicians seek to divide the electorate on issues in which the divider will be allied with a majority of the division). I hardly mean that only the U.S. has had ethnic conflict, but that America's long simmering race and ethnic divisions stymied economic-based coalitions that arose in many other nations.

III. Political Change

A. Political Change and Time Series Data

As politics changes, ownership structure could also change. Thus one could try to measure political change and see if ownership changes. But this kind of longitudinal study is not technically possible right now—the multi-nation historical ownership data are either unavailable or unreliable.[84] Moreover, there are surely lags, of uncertain length, in economic reaction to political change. And, most importantly, one would need to hold the *other* conditions constant. Economic, technological and institutional conditions have changed greatly during the past decades. Economies used to be less competitive—American industry tended toward oligopoly, European firms were small and largely confined to their national economy, and globalization was an idea then for the future. Weaker competition produced more organizational slack, some of which was "spent" in looser ownership and organizational arrangements.[85] It will be hard, or impossible, to do a time-series test that holds these other conditions constant, and measures only politics' effects on ownership structure.

But in gross, recent shifts in Europe are consistent with the social democracy thesis. Economic policy has moved rightward in recent decades in Europe. One cannot simply measure "social democracy" by the name of the political parties in power, as their programs have changed, with social democratic parties becoming less interventionist and less hostile to shareholders. This could lead to other predictions: As economic politics has moved rightward, diffuse ownership has become more feasible in Europe. As it becomes more feasible, the demand from policy-makers and investors could increase (as it has) for institutions that better support diffuse ownership.

Britain illustrates this nicely. All the basic institutions for diffuse ownership, save one, namely a non-social democratic economic consensus,

[84] In a major undertaking, the European Corporate Governance Network has pulled together European-wide ownership data for the mid-1990's. See Marco Becht & Ailsa Röell, Blockholdings in Europe: An International Comparison (1998) (European Corporate Governance Network overview paper). The data is hard to assemble because many nations lack transparent ownership data; i.e., no immediately ready historical databases from SEC filings. Coming up with nation-by-nation data that stretch back for decades (and onto which one could regress political change) is a task for the future, and perhaps an impossible one.

[85] Roe, From Antitrust to Corporate Governance, supra note 26, at 102-127.

were in place in Britain from the 19th century onwards. But right after World War II, Britain's large firm ownership structure was said to be closer to *continental* family ownership structures than to American structures.[86] Britain's economic policy moved rightward during the ensuing decades; not only did Margaret Thatcher's "revolution" overturn British socialism, but Tony Blair's British Labor Party of the 1990's is less of a socialist party than was the party of his predecessors.[87] In the 1980's Britain's securities markets increased massively, much more than they did in the U.S.,[88] which had at that

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[86] Chandler, supra note 74, at 242; Chandler & Daems, supra note 74, at 6 ("Until World War II, the British economy was for the most part an example of family capitalism."); Hannah, supra note 74, at 41, 53 ("The separation of ownership and control … had not progressed far enough to displace founding or family directors from company boards[;] … 119 [out of the 200 largest firms in Britain], or 59.5 percent, [had founding or family directors] in 1948"). Even today, Britain's ownership structure is more concentrated than the American. On average, the largest British firms *do* have a blockholder with just under 10% of the firm's stock (just below the cutoffs for the concentration data used here and in the underlying database from La Porta et al., supra note 6). Becht & Röell, supra note 84, at 11. These blocks are typically held by financial institutions.

[87] Cf. Ralf Dahrendorf, The Third Way and Liberty, Foreign Affairs, Sept./Oct. 1999, at 13 (1999); Andrew Sullivan, The End of Britain, N.Y. Times Mag., Feb. 21, 1999, at 39, 54 ("Blair … had long since lost faith in the sclerotic European social-democratic model …. [H]e made some Clintonite changes: … All were worthy ameliorations of Thatcherism—but no reversal."); Warren Hoge, Tony Blair Rides Triumphant, Either as a Visionary or as a Good Promoter, N.Y. Times, Feb. 2, 1999, at A6 ("Blair says he … will free Britain from the grip of class consciousness, … liberate British business from restrictions that discourage enterprise and punish risk-taking, [and] reduce the poor's dependency on the state … .").

[88] Organization for Economic Cooperation and Development, Financial Market Trends, Feb. 1998, at 18. In 1985, British domestic stock market as a percentage of gross domestic product more than doubled from that of 1975. In contrast, the American percentage rose only modestly.

Market capitalization of listed domestic equity issues as percent of GDP				
	1975	1980	1985	1990
United Kingdom	37	38	77	87
United States (NYSE, Amex, and Nasdaq)	48	50	57	56

Privatization complicates but does not contradict the social democracy thesis. It accounts for some of the big British increase. Firms had been nationalized either because markets demanded a down-sizing that political actors would not permit or because of ideologies of state time an equally conservative government, but one that did not break with the American past as strongly as did the British government of the time.

B. Political Change and Path Dependence

The historical explanation for the emergence of an institution need not explain its current persistence. Political or economic condition A may induce Institution X, Institution X may call forth its complement, Institution B, which becomes embedded in the society. Condition A may disappear, but the embedded Institution B may force Institution X to persist. Or new conditions may arise and require that X persist.

1. Technological and economic preconditions — Thus the United States in the late 19th and early 20th centuries had the political preconditions for public firms—the absence of a strong social democracy—but may have needed other forces too. American technological progress and business conditions at the end of the 19th century made firms demand capital beyond that easily provided via family ownership: huge enterprises became technologically possible and a massive merger movement needed massive financing. In Europe at that time, firms were smaller, locked into local markets, and not demanding huge capital inputs. Although European nations' governments were less socially democratic then than they are now and met the essential *political* prerequisite back then, several lacked the business and technological preconditions; and the largest firms in Europe then were smaller than the largest in the U.S. Even so, securities markets in general were about as well developed in Europe then as they were in the U.S.;[89] this fact tends to demean a pure legal system theory (especially one based on the hypothesis that common law systems protect minority shareholders better than civil law systems), because the common law vs. civil law status was constant, but the

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ownership. Once these social democratic, or socialist, sentiments ended, the firms were privatized.

[89] See Rahhuram G. Rajan & Luigi Zingales, The Politics of Financial Development 76 (Aug. 1999) (U. Chicago working paper) (total securities issuances as a percentage of GNP were higher in France in 1913 than in the U.S. and only slightly lower in Germany). In the 1900-1913 period, French and Japanese firms sold *more* stock in their nations than American firms did in the U.S. Cf. Yoshiro Miwa & J. Mark Ramseyers's Corporate Governance in Transitional Economies: Lessons from the Pre-War Japanese Cotton Textile Industry, 29 J. Legal Stud. __ (2000) (forthcoming) (surprisingly strong equity market in end-of-19th century Japan).

political configuration (these nations were economically more conservative before World War I) differed.

2. Suppressing financial institutions inside the large firm vs. suppressing the public firm's political support — Capital movement is fluid and can be channeled. Capital, corporate structure, and financial flows attract political attention, and the political result will deeply affect the organization of the large firm. In the U.S., populist politics historically suppressed powerful financial institutions and their voice inside the large firm. This suppression especially affected the structure of the very largest firms, because the largest American firms were (and are) too large for even the richest American families to take and retain long-term big blocks. Complementary pro-shareholder institutions developed to support distant shareholding in public firms, both in those public firms that were very large and in those that were merely large, and hence the public firm dominates in the U.S.[90] In contrast, modern European social democratic politics pressures invested capital, and weakens or bars those complementary institutions that support the public-firm. Hence close ownership, both family and institutional, persists.

3. Social democracy as a filter — Even if political preconditions are met, and even if firms are technologically poised for huge capital inputs, those conditions do not *require* that the firms become diffusely-owned public firms by financing themselves via public securities markets. Financial institutions could take large ownership positions, for example.

The United States though did not have financial institutions large enough to play a major role in the large firms emerging at the end of the 19th and beginning of the 20th century. Banks were small and local, and required to be that way. Insurance companies were barred from investing in stock. Thus, with the political preconditions in place, when business conditions demanded huge capital, large-scale institutional finance was not a possibility, and the demand arose to strengthen the institutions, business and otherwise, of securities markets.[91] Some large German firms might have met the

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[90] Roe, supra note 81.

[91] Both Britain and the United States kept their 19th century banks small—Britain via limits on the number of partners for a bank and the U.S. via branching limits—and only with authority to make short-term loans. Continental banks were organized differently. Kevin Dowd, The Battle of the Systems, 154 J. Inst. & Theoretical Econ. 39 (1998). Hence, the path dependence was clear: securities markets were there and banks were not, so corporate players

technological conditions before World War I, and Germany then surely met the political conditions, but many of the largest firms were otherwise financed, relying on large banks of the kind that were not present in the U.S.

I offer this path dependent account—with the original reasons differing from the reasons that explain persistence—for completeness, not as necessary for the political preconditions thesis. Whatever explains the rise of the public firm in the United States and the persistence of concentrated ownership in Europe until now, there are political preconditions to the rise and persistence of the public firm. In the United States these conditions are met; in contrast, modern continental social democracies thus far have mixed badly with the American-style public firm.

C. Political Change and Alternative Formulations of the Thesis

I have thus far looked on the political players as public-regarding actors with sincerely-held views seeking to build the good society, and in social democracies that vision differs from the one prevailing in the U.S. These ideologies might seek to maximize social well-being, but in doing so they reduce the incidence of public firms, securities markets, and diffuse ownership. One can, however, look more crudely at the phenomena, as rent-seeking by employees, one that succeeds thus far in continental Europe, but that fails (or succeeds less) in the U.S.

1. Social democracy as rent-seeking — Interest groups seek laws and structures that will benefit themselves. So, one could see social democracies as the crude success of labor groups. (Or look at conservative nations as the crude success of financial and shareholder interests.) Ideology may help or retard success of one group or another, but, in this public choice view it is raw self-seeking that is at stake. Labor wins in the name of stability in some nations; shareholders win in the name of fluid capital markets in other nations. Concerted arrangements via tri-partite bargaining characterize some nations, as the three players—labor, owners, and the government —negotiate

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used the former; later the demand for protective law arose. See Roe, supra 81.

Both also separated securities dealing from commercial banking. In the U.S. this came via the National Bank Act in the 19th century and Glass-Steagall in the 20th; in Britain this came via stock exchange rules that barred members from having any other business interest, most notably being a commercial banker. Ranald Michie, Different in Name Only? The London Stock Exchange and Foreign Bourses, c. 1850-1914, 30 Bus. Hist. 46, 60 (1988).

corporatist deals. This is not exactly social democracy, but it is government (often) taking labor's side in negotiations inside the firm.

2. Or simple micro-economic foundations — We could begin without using social democracy, with one viewing the firm as having three inputs: capital, management, and labor. Labor institutions are determined first; capital and management are variable. If labor markets are rigid, with employees "owning" their jobs, then management and capital structures will evolve differently there than in economies with fluid labor markets, where employees have few "property" rights in their jobs.[92]

3. Concentrated ownership as facilitating social democratic politics — I have thus far relentlessly viewed politics as independent of business structure, with social democracy inducing, or strengthening, concentrated ownership structures. But causation may run the other way, at least at times.

German codetermination again provides a concrete example. Earlier in this century, the visible power of Germany's large banks, people's envy and resentment of rich industrialists, and the disorientation and anomie induced by Germany's rapid transformation from an agricultural nation to an industrial one may well have helped call forth codetermination to tame the bankers and industrialists, and to give the workers voice in the strange new industrial enterprises. Corporate structure may have induced politics then, as much as it was induced by politics. Not all productive arrangements are equally stable politically; some induce political opposition, some a democratic polity finds more acceptable.[93] Social democracy and concentrated ownership mutually reinforce one another.

4. Rent-seeking in small national economies — Business structure may be the cause, inducing social democratic politics in another way. Many of the strongest social democracies have been small nations, in which product markets have been less competitive, because only a few firms can reach efficient economies of scale. Weaker competition produces rents—profits above those needed by capital to invest—and these rents can be captured not just by the capital-owners but shared with managers and employees. There is thus more "give" and more of a possibility of successful rent-seeking through government and social action when there are supra-competitive

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[92] Cf. Charny, supra note 24.

[93] See generally Mark J. Roe, Backlash, 98 Colum. L. Rev. 217 (1998).

profits. These rents may also strengthen social democracy by increasing envy and perceived unfairness. And they may provide more to fight over. Rent-seeking employees may win more often in small economies, especially those whose oligopolistic firms are not fully exposed to world markets.

When product market competition is fierce, rents are reduced and excess profits competed away. One reason for American exceptionalism may be that the American economy has been more competitive, making rents here smaller and more fragile (i.e., more easily lost as they will be competed away and therefore less worth seeking).[94] In the smaller national economies, rent-seeking below the surface and social democratic ideologies above it could have produced concentrated economies unable to strongly support diffuse stockholders. The parallel here between corporate results and James Madison's famous analysis in the Federalist No. 10 is obvious.

As the small economies integrate into free-trade zones, the potential for local rent-seeking will diminish, enhanced product market competition will make traditional social democratic corporate governance harder to maintain, and the demand for securities institutions will rise.[95] Governments whose firms face intense competition that renders them unable to implement a social democratic program through firms or labor markets may either abandon their goals or implement them via social insurance that leaves firms out of the picture.

5. Craving stability — Social democracy may not fully capture the ideological metric here. Some nations may crave stability more than do others. Histories of war, devastation, social instability, market collapse, or starvation can drive this craving. If voters crave stability, they may insist on rules and a business atmosphere that make change harder than it would

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[94] Even modest rents create indeterminacy in corporate ownership and governance. Rents allow different players to get value out of the firm, and different players may win by chance in some political environments and lose in others. When competition in the American economy was weaker, and oligopoly stronger, mild pressures to soften the workplace and make managers socially responsible to employee constituencies may have been more effective than they would be today. See Roe, From Antitrust to Corporate Governance, supra note 26.

[95] Whether path dependence diminishes the demand for corporate change is analyzed in Lucian A. Bebchuk & Mark J. Roe, A Theory of Path Dependence in Corporate Ownership and Governance, 52 Stan. L. Rev. 127 (1999).

otherwise be. The core cause though may then not be social democratic ideology, or employee rent-seeking, but a society seeking stability.[96]

6. Managers' utility functions — Another way to look at this issue could be through managers' utility functions. Human nature does not demand that managers maximize, say, firm size or profitability. In cultures that emphasize other values, and inculcate them through schooling and other means, managers may maximize something else, and that something else may make them less able, or less willing, to do shareholders' bidding.

IV. Reservations and Refinements

A. Conventional Explanations

Social democracy is not the conventional explanation for concentrated ownership. Accounting, culture, and law are conventionally said to explain the differences in ownership structure around the world.

If accounting is confusing and opaque, distant shareholders are made wary of buying stock in firms that they cannot understand. But bad accounting explains concentrated ownership poorly. Not only can firms and nations readily modernize their accounting systems, but individual firms can adopt American accounting rules, hire auditors, and insist that the auditors warrant to investors that the firm's accounts are kept in accordance with American generally accepted accounting principles. And if that is too American-centered, firms can use the International Accounting Standards, as have some European firms.[97] Indeed, prior to the passage of the American securities laws, better firms voluntarily delivered such statements to investors even when the law did not require them to do so. And in today's world good national accounting institutions correlate poorly with diffuse ownership.[98]

[96] Karl Polanyi, The Great Transformation (1944).

[97] Graham Bowley, Great Leap Towards America, Fin. Times, May 1, 1997, at 5; Semler, supra note 13, at 278; cf. Joël Morio, En France, Les Balbutiements de l'Information Financière, Le Monde, Nov. 11, 1998, at 18 (several major French firms, consciously following American practice, decide voluntarily to publish quarterly results).

[98] Wendy Carlin & Colin Mayer, Finance, Investment and Growth, at 13, 33 (Oxford working paper) (Oct. 1998).

Cultural explanations point to Europeans' aversion to buying equities and their purported aversion to creative entrepreneurial action.[99] These aversions may be real, and cultural explanations are notoriously hard to disprove. But one wonders why on both sides of the Atlantic so many business practices have converged, but this one has not. It's possible that social democracy diminishes the supply of entrepreneurs by denigrating entrepreneurs and then decreases entrepreneurial opportunities for those not otherwise deterred. Again, this may be a price, perhaps a small one, of making life better for more people in a social democracy.

Other explanations must also be incomplete. Pension funds are big players in the American stock market; in continental Europe publicly-provided pensions are stronger, diminishing the opportunity for private pensions to fill in the retirement demand and thereby create deep pools of capital to invest in the stock market.[100] If we looked only at institutional arrangements today, the lack of private pension funds seems a strong explanation. But the diffusely-held Berle-Means firm preexisted the rise of private pension funds in the United States, making this explanation a current and only partial one, not an historically complete one. Pension funds may sustain, and their absence retard, a deep securities market, but they could not be a primary cause.

Today's most popular academic explanation for why Europe lacks deep and rich securities markets has quickly become the role of law in protecting minority stockholders.[101] But weak technical law is unconvincing

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[99] See, e.g., Ruggiero, supra note 5, at 86; Peter Gumbel, Cracking the German Market—The Hard Sell: Getting Germans to Invest in Stock, Wall St. J., Aug. 4, 1995, at A4.

[100] Ailsa Röell, The decision to go public: an overview, 40 European Econ. Rev. 1071, 1072, 1078-79 (1996) ("negative relationship between the size of the stock market and the proportion of GDP devoted to public pensions…").

[101] A major European-wide research network, leading financial economists, including one Nobel Prize winner, and leading legal commentators have taken up the law-driven theme. La Porta et al., supra note 6; Lucian Arye Bebchuk, A Theory of the Choice Between Concentrated and Dispersed Ownership of Corporate Shares and Votes (Harv. Law & Econ. working paper, Oct. 1998); Becht & Roëll, supra note 84 (overview paper from the European Corporate Governance Network); Carlin & Mayer, supra note 98, at 9, 13, 18-19, 25; John C. Coffee, The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications, 93 Northwestern U. L. Rev. 641 (1999); Franco Modigliani & Enrico Perotti, Security versus Bank Finance: The Importance of a Proper Enforcement of Legal Rules (working paper, Nov. 1998).

as the root cause of corporate ownership structure in the world's richest nations, for reasons we shall next see. Technical explanations can easily be exaggerated—after all, technical defects may be remedied, and their persistence may *result* from stronger forces. Deeper social fissures affect corporate governance, social fissures can wedge open the space between managers and distant shareholders, and can make it not worthwhile for key corporate players to build the technical institutions needed to support the public firm.

1. Technical law: Protecting minority stockholders — Imagine a nation whose law badly protects minority stockholders against a blockholder extracting value from small minority stockholders. A potential buyer fears that the majority stockholder will later shift value to itself, away from the buyer. So fearing, the prospective minority stockholder will not pay pro rata value for the stock. If the discount is deep enough, the majority stockholder may decide not to sell, and concentrated ownership will persist.

One can imagine a law-driven process. In the U.S., France, and Germany, founding owners sell stock to minority stockholders, who naively buy from the controller. A few years later the controllers in each nation rob the minority stockholders through fraud (by lying about the true state of the firm and then afterwards buying up the stock cheap) or interested party transactions (by forcing the corporations to buy raw materials at inflated prices from firms in which the controllers have strong positions). Or the equivalent occurs: the founders sell out their entire position to the naive public buyers, but then a raider attacks, takes a control block, and shifts value from the public stockholders to himself. In the United States, the supple, adaptive common law judge hears the case, bangs the gavel and does justice, protecting the minority stockholder; securities markets flourish. In France, Germany, and Italy, the civil law judges adopt formalistic reasoning that fails to protect the minority stockholders; securities markets wither.[102]

Two core theoretical problems afflict this law-driven model. First, the minority protection argument tells us that minorities would feel *more* comfortable in "protective" nations than in non-protective nations. Hence, the

[102] If the public stockbuyers are non-naive, the selling blockholders are not without self-help contractual remedies to stymie raiders. Capped voting, mandatory bids, and voidable interested-party transactions can reduce or end the buying stockholders' fears if the nation enforces contract satisfactorily, even if its corporate law is weak. See supra note 7 & infra note 121.

United States could, all else equal, if law were the driving force end up with *many more* blockholders in those firms that go public. Blockholders provide critical good services to the firm and one powerful bad service: the good ones are monitoring managers,[103] facilitating information flow from inside the firm to capital owners,[104] and making implicit deals with stakeholders when soft deals are efficient;[105] their one big bad activity is their stealing from the minority stockholders.[106] But if a nation's laws control the costs of their potential to do bad, then one would expect that nation's firms to get *more* blockholders, not fewer.[107] Yet the U.S. has *fewer* blockholders.

True, diffusion allows family owners to diversify, by lowering the cost of selling out, because well-protected minority owners will pay full value. Thus better minority protection lowers the costs both to distant stockholders of living with blockholders, and to blockholders of selling out. This trade-off makes the law-driven argument theoretically ambiguous.

And using minority protection to explain why blocks persist is also ambiguous. If blocks persist, one cannot *a priori* know whether they persist because minority stockholders fear the controller, or because they fear the *managers*, who might either steal from them or run the firm into the ground if the controller disappears from the firm. If they fear unrestrained managers,

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[103] Andrei Shleifer & Robert W. Vishny, Large Shareholders and Corporate Control, 94 J. Pol. Econ. 461, 465 (1986) ("our analysis indicates that [by monitoring managers] large shareholders raise expected profits and the more so the greater their percentage of ownership").

[104] Roe, supra note 81, at 260-61 (large owners mitigate); Jeremy C. Stein, Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior, 104 Q. J. Econ. 655 (1989) (diffuse ownership creates informational inefficiencies).

[105] Cf. Andrei Sheifer & Lawrence Summers, Breach of trust in hostile takeovers, *in* Corporate takeovers: causes and consequences 33-56 (Alan J. Auerbach, ed.) (1988).

[106] Blockholders not close to the company could be too poorly informed to monitor valuably. See Chandler, supra note 10. These blockholders should disappear in time because they cannot add value.

[107] The controller maximizes the sum of two values: "best management ('social optimality') and … the value of the securities … ('private optimality')". Milton Harris and Artur Raviv, Corporate Governance—Voting Rights and Majority Rules, 20 J. Fin. Econ. 203, 205, 207 (1988). Good law by controlling "private optimality" will allow for more control blocks that, by better assuring best management, will yield social optimality. True, because the controller cannot capture all of the benefits of improving the firm, it will invest suboptimally: if the controller owns 25% of the firm, it will want an expected increase in firm value equal to four times that of the resources it expends to improve the firm.

the controller cannot sell stock at a high enough price and thus she keeps control to monitor managers or to run the firm.

Background rates may lead European analysts to mis-identify the underlying causes: Because blockholding is common, its visible costs in insecurity for minority stockholders are vivid to the analyst of continental Europe's corporate governance system. But continental Europe's visible institutions mask that they also control managerial agency costs in a diffusely-owned firm poorly. Dominant stockholders may be visibly weakly controlled, but managerial agency costs in public firms may be *even more weakly controlled but unobserved because there are so few truly public firms. And there may be so few truly public firms because their institutions wedge open the gap between managers and shareholders, because institutions that would control Anglo-Saxon-style managerial agency costs on the continent are weak, and because owners faced with potentially high managerial agency costs use structures other than the American-style public firm.*

Defenders of poor minority stockholder protection as the driving force could rephrase their argument: A *minimal* condition for Berle-Means firms is that majority stockholders be unable to devastate the minority stockholders. Only once that minimal condition is met can the public firm flourish. Although restating it this way is rhetorically stronger because the defenders minimize their needed showing, the restatement still fails, because one could re-state the agency cost perspective similarly: A minimal condition *for Berle-Means firms* is that managers be unable to steal the firm, run it into the ground, or excessively disfavor shareholders, with impunity. When big blocks persist, we cannot *a priori* tell *which* minimal condition is unfulfilled.[108]

Most realistically, the minimal technical conditions are satisfied in the world's richest nations, because all have *some* public firms, *some* public stockholders, and *some* firms with concentrated ownership. With minimums met everywhere, the question shifts from minimums to differences, as we do next.

2. The gap: Controlling dominant stockholders vs. controlling managers — If technical corporate law were the driving force in the

[108] And it's theoretically easier for the managerial precondition to be unsatisfied, because a firm can jump from close to diffuse ownership and bar a new controller from entering (via capped voting, friendly blocks, etc.). Cf. Jensen & Meckling, supra note 7 (owner has incentives to maximize firm value when the firm first goes public).

advanced western nations, then the *gap* between a nation's ability to control managerial agency costs and its ability to reduce a majority stockholder's ability to rip-off minority stockholders would determine ownership structure.

When a nation controls managerial agency costs better than it prevents blockholders from ripping off minority stockholders, it will get more diffusely-owned, public firms. If it controls minority rip-off well, but fails to control managerial agency costs as well, it will get many blocks and few public firms. When it controls both poorly, it will get more closely-held, privately-owned firms than otherwise.

3. Contract law and corporate law: Is an enforceable contract good enough? — If law is truly atrocious, then, whatever a nation's underlying political reality, the public firm and complex commercial institutions cannot emerge. A nation must enforce *contracts* satisfactorily before it can build complex private institutions.[109] But "more" law is often unnecessary, nor always better; moreover, once contract is enforced satisfactorily, it's plausible that social, political, and financial reality drives whether corporate law will be refined further, and not, as the currently popular explanation runs, technical corporate law that by itself creates or destroys the public corporation.

With adequate contract enforcement, institutions can (and, in the U.S., did) roughly replicate securities laws and corporate law. Indeed, critics wonder whether comprehensive legislative schemes are more likely to make errors than to promote investors' and corporate needs.[110]

(a). Flat bans vs. fiduciary duties — An example: Much is made today of fiduciary duties as facilitating the rise of the public corporation and

[109] As many law school students quickly recognize, the second-year corporations course extends the first-year contracts course.

[110] See, e.g., Roberta Romano, The Genius of American Corporate Law (1993); Ralph Winter, State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977). We need not resolve these debates to see that good contract enforcement, which, once in place, permits private parties to build some needed institutions, *as they first did in the United States*, via stock exchanges and voluntary offers of information. True, such private institutions are imperfect: private parties cannot criminalize misbehavior, standardization is sometimes most cheaply done by public authorities, and transaction costs are sometimes lowered via government and judicial intervention. But imperfection does not mean that complex legal institutions must pre-exist the rise of a securities market. Cf. Frank H. Easterbrook and Daniel R. Fischel, The Economic Structure of Corporate Law (1991).

the separation of ownership from control. Via fiduciary duties, American judges police related party transactions in which insiders profit at the expense of outsiders. However, American fiduciary duties *loosened* the prior U.S. standard, which had *banned* related-party transactions (or, more accurately, made them voidable).[111] *Fiduciary* duties need a sophisticated legal system,[112] but an outright *ban* in the corporate charter—which is nothing more than a contract—needs only simple but good contract enforcement. To the extent outside investors need to be protected against insider over-reaching, *either* well-enforced fiduciary duties *or* a well-enforced, simple ban will protect the shareholders, a task that contract can accomplish. Indeed, European commentators sometimes marvel at the rich methods of thievery that can arise under American "loose" fiduciary standards, but, they claim, are unimaginable under the flat bans that prevail in some European nations and that once prevailed in the U.S.[113]

(b). Failure to enforce contract — Bad law sufficiently explains weak securities markets where law is *so* weak that even *basic contract*s cannot be enforced—as they cannot be in contemporary Russia, many transition economies, and significant parts of the less developed world—thereby rendering complex corporate institutions impossible.[114] This

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[111] Howard Marsh, Jr., Are Directors Trustees? 22 Bus. Law. 35, 36-37 (1966). Marsh's statement has been challenged: treatises of the time stated the rule in modern terms, with interested-party contracts voidable only if disinterested directors failed to approve the transaction. Norwood P. Beveridge, Jr., The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction, 41 DePaul L. Rev. 655, 659-62 (1992).

[112] One topic to investigate is the relative role of law and of American anti-institutional rules that simply decreased the *incidence* of blockholding. Cf. Roe, supra note 81.

[113] André Tunc, A French Lawyer Looks at American Corporation Law and Securities Regulation, 130 U. Pa. L. Rev. 759 (1982); cf. Fabrizio Barca, On Corporate Governance in Italy: Issues, Facts and Agenda 17 (Bank of Italy working paper, Feb. 1995) (flat contract and charter terms reduce opportunism in Italy in areas where fiduciary duties are weak).

[114] Bernard S. Black & Reinier Kraakman, A Self-Enforcing Model of Corporate Law, 109 Harv. L. Rev. 1911 (1996) (Russia); Jeffrey D. Sachs & Katharina Pistor, Introduction: Progress, Pitfalls, Scenarios, and Lost Opportunities, *in* The Rule of Law and Economic Reform in Russia 1, 3 (Jeffrey D. Sachs & Katharina Pistor, eds., 1997); cf. Raghuram G. Rajan & Luigi Zingales, Which Capitalism? Lessons From the East Asian Crisis, 11 J. App. Corp. Fin. 40, 41 (Fall 1998) (East Asia); Röell, supra note 100, at 1079 (Italy); Luigi Zingales, The Value of the Voting Right: A Study of the Milan Stock Exchange Experience, 7

insight is important *to understanding finance in nations with decrepit legal systems*, but it cannot be extended to advanced nations to conclude the converse, that if they lack a good securities market, it's because their law is not advanced enough. To assume defective contract law in Denmark, France, Germany, and Sweden would be mistaken. All the Scandinavian nations, Germany, and several others enforce contract *as well as does* the United States.[115] Studies of business climate are consistent: continental Europe and the Anglo-Saxon basic *business* institutions are seen as *equally* business-friendly generally, but the continental European *labor* markets are seen as *much* less business-friendly.[116]

Nor is it logically correct to assume that where corporate rules are weakly enforced, that is the primary cause for weak stock markets in nations that have already built satisfactory contract and property institutions. In such nations, were there sufficient demand for diffuse ownership—were the *political* conditions otherwise propitious—investors and firms could build the institutions needed for good securities markets.[117] If they have not, then a deeper and non-legal reason must explain why. Each of these European nations has been a social democracy, and politics again explains the results better than does law.

(c). The stock exchanges: How much corporate law was necessary? — The *sequencing* in the U.S. should dampen enthusiasm for a purely corporate-law driven thesis. American securities laws came well *after* the rise of the public firm. Critical early rules were created by private means *to control concentrated owners* via the simple-to-enforce contractual sanction of excluding the recalcitrant firms from the stock exchange. Stock

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Rev. Fin. Stud. 125, 146-47 (1994) (Italy); Lorenzo Stranghellini, Corporate Governance in Italy: Strong Owners, Faithful Managers, 6 Ind. Int'l & Comp. L. Rev. 92, 178-83 (1995) (weak enforcement in Italy).

[115] Kim E. Holmes et al., 1997 Index of Economic Freedom 160, 185, 199, 346, 422, 457 (1997); cf. Ross Levine, Law, Finance, and Economic Growth, 8 J. Fin. Intermediation 8, 14-15, 20 (1999) (index of risk that government will respect a contract it has signed: high for the U.S., but *higher* for France, Germany, and Scandinavia).

[116] Jeffrey D. Sachs & Andrew M. Warner, Executive Summary, *in* World Economic Forum, The Global Competitiveness Report 1998, at 24.

[117] Institutions will sometimes not be built for other reasons: Incumbents (such as controlling families, favored labor institutions, existing non-securities financial institutions) may seek to block building them. This is another political reason why securities markets do not arise, one that does not begin primarily with bad law as the cause.

exchanges determined what rules they needed to make stock saleable, imposed them via contract (in the listing agreement), and enforced them through exclusion via de-listing the recalcitrants. Listed companies, for example, had to issue financial statements before annual meetings, the statements had to be audited by independent auditors, and reports were encouraged to be quarterly.[118] Indeed, the New York Stock Exchange may have grown precisely because New York courts would *not* enforce some common securities trading contracts, while the stock exchange could, via exclusion.[119] Analysts conclude that the 1933 and 1934 Acts merely codified best practice as exemplified by the New York Stock Exchange rules. If other nations with good judicially-enforced contract law—or with histories of strong guild-based private enforcement—do not create these simple institutions, then one might wonder why, especially for nations like France and Germany that historically have built many other complex and effective institutions: the best hypothesis is that the institutions did not arise because the demand for them just was not there. And the demand for them has not been there because the underlying political reality made the public firm inappropriate for stockholders. It's less that law determines the institutions than that politics determines which

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[118] George J. Benston, Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934, 63 Am. Econ. Rev. 132 (1973); Stuart Banner, The Origin of the New York Stock Exchange, 1791-1860, 27 J. Legal Stud. 113, 114 (1998) (NYSE succeeded by "formulating rules to govern the new securities market"); Paul G. Mahoney, The Exchange as Regulator, 83 Va. L. Rev. 1452, 1466 (1997). The following summary should give one pause before concluding that hard corporate law is the sine qua non (as opposed to a transaction-cost reducing luxury)—of controlling dominant stockholders in family-run public firms:

> When the NYSE first instituted [its disclosure] requirements in the late nineteenth century, many listed companies were effectively *family businesses* with a minority public stake [similar to European continental firms today]. The original proprietors were reluctant to abandon their instinct for secrecy … . Nevertheless, the NYSE prevailed. Beginning … in 1910, the Exchange's Committee on Stock List carried out a vigorous and successful campaign to improve the quality and quantity of disclosure. … *[T]he turning point for disclosure practices [was] 1900, rather than 1933.*

Id. at 1469-70 (emphasis added; footnotes omitted).

[119] Banner, supra note 118, at 126, 132 (NYSE creates its own "miniature legal system," with expulsion as principal sanction).

institutions will work well, and from there the supporting legal institutions arise.

(d). Capped voting and poison pills. Another take on contract theory, imagining the motivations and range of actions of the controller at the time of the IPO, casts doubt on the pure law-driven theory. Suppose a controller in the style of Jensen and Meckling's value-maximizing offeror is trying to maximize his or her total proceeds when taking the firm public.[120] If the principal constraint on realizing full value for their stock is that outsiders fear the depredations of blockholders, the controlling stockholder will minimize that possibility by minimizing the possibility of blockholders controlling the firm. First off, the controller can theoretically sell *all* of his or her stock in the initial offering, or soon thereafter. Founders in Britain now rapidly exit the firm after the IPO.[121] The controller who credibly commits to selling out quickly could get full value for the firm, *unless* the agency costs of the resulting structure are so high that he or she has to stay in to influence the firm and its managers.

True, minority stockholders will fear that *outside* raiders will acquire a control block and then rip them off. Hence, they will not pay full value even if the controller credibly commits to leave. But the controller can minimize the buyers' fears of the outside raider. The controller can write charter terms that reduce the raider's capacity to acquire a control block. Enforcing these types of clauses requires neither unusually strong courts nor unusually perceptive judges. Capped voting—by which no holder is allowed to vote more than, say, 5% of the votes at the firm's shareholders' meeting, no matter how much stock he or she owns—can prevent a new controller from entering. It played a role in late 19th century Japan, when securities markets emerged in Japan's large cotton industry, despite weak corporate law.[122] Its lackluster history in Europe in recent years—a few firms in Germany used it for awhile, then it was barred, but grandfathered, and most companies abandoned it—suggests that it was creating more problems than it was solving. Capped voting arose not to control blockholders generally, but to deter specific foreign oil interests from taking over a few major German firms. Perhaps it could not work in a country where managerial agency costs

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[120] Jensen & Meckling, supra note 7.

[121] [Brennan & Franks, supra note 75.]

[122] Yoshiro Miwa & Mark Ramseyer, The Value of Prominent Directors: Lessons in Corporate Governance From Transitional Japan (working paper, 1999).

would be high, because it shields managers from outside influence. This would, of course, be inconsistent with a pure law-driven thesis, but it's consistent with a managerial cost thesis, such as the social democracy thesis.

Poison pills make it costly for any new acquirer to acquire only a block, and thereby induce the acquirer to tender for all of the company's stock. These would also facilitate the firm going fully public without the shareholders fearing deeply that a new acquirer would take a block and shift value to itself. These pills are widespread in the United States. A company that uses a pill would, however, raise agency costs by shielding managers from many takeovers. That would make its use inappropriate in a firm susceptible to high managerial agency costs.

A foreign firm can even adopt American law by forming an American holding company to issue the stock. True, high transactions costs of issuing stock in the U.S. might prevent this. But some European firms *already* incur these costs and sell stock on NASDAQ, but, I understand, rarely if ever use a Delaware corporation to issue that stock. If they incur the transaction costs of selling in the U.S., but do not sell through an American firm, then, absent an added transaction cost (such as taxation of the transaction), getting American law and minority stockholder protection is just not that important for them.

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Thus, nations unable to enforce basic contract law—like Russia and many transition economies—lack the legal institutional prerequisite to building public firms and securities markets. But many wealthy nations—the Scandinavian nations, Germany, and France—have good contract law, yet do not have many public firms. They have not had many because investors' demand for them has been low; and investors' demand has been low because they have been social democracies in which diffuse ownership and securities markets have been unstable. Moreover, good securities law is not a prerequisite, as the American sequence shows: the key American laws came *in 1933 and 1934, after* the rise of the public firm and diffuse ownership. Once a minimum is reached, law is less a determinant of a society's business institutions than a result.

4. Weak corporate law and social democracy: Which is cause, which effect? — The thesis here is that social democracies stymie diffuse ownership, not that more conservative governments necessarily induce it. Other criteria have to be met: economic (do technologies of scale make big firms efficient?), institutional (are there enough risk-bearing institutions?), and legal (will the legal structures support diffuse ownership? is institutional block ownership suppressed?). A strong social democracy tends to filter out diffuse ownership; it isn't the only filter.

Accordingly, although one might try to contradict the political thesis by finding a few economically conservative governments, historically in Europe or currently in Asia or Latin America, that have had little diffuse ownership, the thesis would thereby be misunderstood, not contradicted. It's not that the non-social democracies cause diffuse ownership. Rather it's that social democracies destablize diffuse ownership. (Or, restated more formally, non-social democracy is usually a necessary but never a sufficient condition, for widespread diffuse ownership.) Social democracy is not the sole determinant.[123]

Another criticism of the thesis here could be that social democracies are as much in tension with rich family owners who found and run businesses as they are with diffuse stockholding. The families are people whom, to sharpen this criticism, we can call here the tycoons. Their wealth, especially if ostentatiously displayed, will be unloved by the social democracy. They may be detested more than the managers, let's say faceless managers, who would run diffusely-owned firms as technocrats.

This could all be true, but would miss the point here. The point is not that managers incur the ire of social democracies and that concentrated family owners do not. Both may well be unpopular in the social democracies. The point is that the weak ties between managers and shareholders are more at risk of fraying in a social democracy than in a more economically conservative nation, and this weakness destabilizes the public firm in a social democracy. The families could incur *more* social democratic ire—of course, they may "invest" in being patrons of the arts, of good health, of a social compact, to defang that ire—and *still* survive because the families can tie managers more tightly to themselves than can diffuse shareholders in a social democracy. The polity may conceivably hate the families more, but inside the firm they can resist social democratic pressure better than the Berle-Means managers.

5. Reforming law — Monocausal explanations, whether resting on insider trading rules, legal protection of distant stockholders, accounting

[123] It may not be easy to contradict the thesis even factually by looking at Europe's conservative pre-World War I governments. Contrary to the usual assumptions in the U.S., they had nascent securities markets that by many measures were as strong as American securities markets at that time. See supra note 89.

transparency, institutional history, or a nation's place on the political spectrum, are inherently incomplete. I do not wish to displace the other explanations completely, but rather to open up space for the unrecognized social democracy explanation. Because there are multiple factors, even if social democracy is the most powerful explanatory force— explaining, say, half of the variation in the world today and historically, anomalies will exist. A few nations today, or historically, lacked all the economic and institutional but not the political preconditions and accordingly ended up with concentrated ownership, or, vice versa, lacked the political but had all the other preconditions, and so got a few public firms anyway. Apparent counter-examples may not mean that social democracy is absent as a force, but that every other force lined up the other way. Better than trading isolated examples is to examine across-the-board data, and the data show there are few such anomalies today and might in time as data improves show few such anomalies in the past.

Nor do I wish to denigrate reform aimed at improving the technical prerequisites to the public firm. *Some* of the explanation is technical. In statistical terms, using a legal variable and the political one each explain 40% of the variation in ownership concentration (and the two though are not entirely collinear). One should not lean solely on technical, corporate law explanations, as does the currently dominant literature.

Technical failures can exist and persist due to politics for at least two reasons: currently favored groups may resist change *and*, if the Berle-Means firm is inherently unstable in a social democracy, the *demand* from the players who might profit from change (managers, family-owners making their initial sale of stock, public-regarding governmental players) may be low; the players may find it not worthwhile to invest resources in technical change that would bring only paltry private profits.[124] The task of technical reform may be worthwhile, but frustrating.

One should not denigrate reform projects for another reason: *the technical reforms can sometimes change underlying political realities*. New groups could be empowered, old groups disfavored, and new ways of doing business can be discovered, favored and stabilized. (Because of these effects, favored incumbents resist change.) It's plausible that the American history of fragmenting financial institutions induced the American electorate to tinker *less* with shareholder wealth maximization institutions than it would

[124] Cf. Bebchuk & Roe, supra note 95.

have: concentrated, visible financial institutions would have been an easy political target. American rules removed one of the most visible anti-shareholder targets. Again, a shareholder wealth maximization norm may be viable if those shareholders are exemplified by CalPERS, California's public employees pension fund, than by a cigar-chomping J.P. Morgan.

The political-driven theory here interacts with a law-driven theory in two possible ways. One, it may explain why legal institutions do not develop. Building corporate law institutions, even if rarely rocket-science, costs somebody something. If the players who would build them—public policy-makers, investors, and managers—cannot profit from them, they will not invest in building them. Hence, the current literature over-emphasizes law as a driving force in determining corporate governance structure. A minimum must be reached of, say, good contract enforcement or minimally satisfactory corporate law (via outright bans or fiduciary principles). Once the minimums are reached—and, since all of the richer nations have some public firms and some public stockholders, all have reached those minimums—it's then the nation's means of settling social conflict, of building a financial system, and of affecting loyalties inside the firm that will determine which structures fit best. From there, the remaining needed law, if any more is needed, will come. Law then becomes more result than primary force.

True, when one runs the statistical tests I show in Part II and the Appendix using technical legal indicators *and* political orientation, one gets a much stronger correlation than using either one alone. This suggests that perhaps the political index is "noisy", or that the quality of legal institutions is partly independent of politics. Combining the two theories explains the world's patterns better than does either alone.

Two, the social democracy theory may contradict the law-driven theory. Good law may arise—Sweden may be an example [125]—but ownership may *still* not separate from control, *despite* good law, if the nation's political environment would make separation too costly for distant stockholders.

Blocks and diffuse stock often have different values. That is, oftentimes control blocks trade at a price higher than the pro rata trading value of smaller, noncontrolling blocks of stock. A good explanation for the difference is that the controller can get private value from control, some from

[125] Not only are the qualitative assessments of Swedish corporate and contract law high, but the result—the premium for owning a controlling block is as low as it is in the U.S.—is measurable.

the prestige of running the business, some from the ability to divert value to himself or herself, some from the ability to manipulate tax results. But when these firms rarely convert to diffuse ownership, we do not know why: if the minority stockholders would fail to gain from diffuse ownership, because, due to higher managerial agency problems in the diffusely-held firm, they would lose as much as they lose to controlling stockholders in the closely-controlled firm, then neither policy-makers nor the diffuse stockholders would push for laws making diffuse ownership easier. Each may know that outside stockholders would do no better if ownership were diffuse, or intermittent reforms may go nowhere because firms do not thereafter become more diffusely-owned, and the demand for further reforms dissipates.

Distinguish two kinds of agency costs here, those that shift value inside the firm among stockholders (and managers), and those that dissipate value. Take a firm worth $100 to the controller, who owns it all and considers whether to take the firm public. When the controller sells 50 of the 100 shares to the public, we observe that the stock is worth only $40 to the outsiders, and the controller's block is worth $60. From this one *might* conclude that blockholders are not well-regulated in that nation and that this induces the controller to retain control, because otherwise she'd be leaving $60 on the table for future raiders to steal.

But the full reality there may be deeper. Those who argue that poor protection of minority stockholders is the key *assume* that the firm, were it to go fully public and turn into a diffusely-held firm, *would continue to be worth $100 to stockholders*. But this cannot be assured. The fully public firm might only be worth $80 to stockholders: managerial agency costs could rise and shareholder value decline in the fully public firm.

If so, the controller would retain the control block not to keep the private value of control (the $20 difference), but because the diffusely-held firm will control managers poorly *and be worth less to stockholders*. (The lower value in the fully public firm may come from managers frittering away capital, *or* it may be redistributed to others, presumably the employees. Whether society as a whole loses is ambiguous, just as whether social democracy lowers aggregate national wealth is ambiguous. But in driving capital structures, what counts initially is whether the shareholders lose, not whether others win.)

Table IV
Outside stockholders' value when controlling stockholder favored

	Shares owned	Value owned	Value per share
Controller's block	50 shares	60% of value	$1.20 per share
Outsiders' shares	50 shares	40% of value	$ .80 per share
Total of firm	100 shares	100% of value	$100
Controller's total			$ 60 shares 40 cash $100

Table V
Outside stockholders' value in public firm when agency costs high
(controller's total value declines; outsiders' per share value remains constant)

	Shares owned	Value owned	Value per share
Controller's block	0		
Outsiders' shares	100 shares	100% of value	$ .80 per share
Total of firm	100 shares	100% of value	$ 80
Controller's total			$ 80 in cash

Would outside stockholders, seeing the excess value in the controller's block, nevertheless want to foster diffuse ownership? No. Outside stockholders in such a setting *would have no incentive to foster diffuse ownership*. They will end up with $40 in the fully public firm, and they end up with $40 as stockholders in the controlled firm. They cannot augment their wealth by inducing the transaction that would make the firm fully public, nor can they profit by inducing their nation to build the supporting institutions.

True, outside stockholders would like to divide the value up evenly *in the concentrated firm*, but the controller would oppose reforms favoring existing minority owners; standard public choice analysis handicaps the concentrated owner as the likely political winner. *But whichever* one wins, *concentrated* ownership would persist, because *total* shareholder value would decline if the controller broke up the block. (If the minority won and got good law, the controller's *block* would be worth $50 (and the firm worth $100), but she would only get $40 (and the firm would be worth $80), if she sold it to the public. Hence, *even with good minority protection in place,* she would lack the incentive to sell her block.)

Table VI
Stable concentration even if minority stockholders are later protected
(controller's value higher if block retained; compare Table VI to Table V, $90 versus $80)

	Shares owned	Value owned	Value per share
Controller's block	50 shares	50% of value	$ .50 per share
Outsiders' shares	50 shares	50% of value	$ .50 per share
Total of firm	100 shares	100% of value	$ 100
Controller's total			$ 50 in shares $ 40 cash $ 90 total value

B. Governmental Discretion and Social Trust

1. Discretion. — Related to the theory that minority stockholder protection drives the ownership results, is an idea that nations whose governments retain key decision rights over the firm will not get public firms, but those whose governments give them up will tend to get public firms.[126]

While attractive to legal academics—we prefer the rule of law—the idea survives neither theoretical nor empirical analysis. The theoretical difficulty is that the idea fails to connect up well to the micro-structure of the firm. Decompose the firm into three parts: shareholders, managers, and employees. Four types of governmental discretion could be relevant: discretion that favors shareholders, that favors managers, that favors employees, or that jumps from one to another. A government that retains discretion *but that usually exercises it in favor of shareholders*, will not deter public firms. Similarly, a government that retains discretion, but that usually exercises it in favor of managers, may or may not deter the public firm, depending on how the firms' micro-institutions fit together: if managers are tied to shareholders (via stock ownership, board structure, social norms, etc.), then discretion favoring managers need not deter the public firm. A government that retains discretion, but that usually exercises it in favor of

[126] Curtis J. Milhaupt, Property Rights in Firms, 84 Va. L. Rev. 1145 (1998).

employees will tend to get close ownership and few public firms, as long as close ownership can blunt the government's efforts often enough (by hiding information, by stymieing government enforcement, by directly influencing government, perhaps via bribery, not to favor employees, etc.). And a government that sometimes favors one group, sometimes another, may or may not stymie the rise of the public firm. It makes the environment riskier, but one cannot tell *a priori* how risk will affect ownership. (It may raise the demand for diffuse ownership so that shareholders can diversify their risks, by owning a piece of each firm into which the government might intervene. Or it might induce more concentrated ownership, if the concentrated owners can act to reduce the risks and consequences of government intervention.)

Only one exercise of governmental discretion of the four—that favoring employees—can stifle the public firm. This discretion is best captured in the idea of social democracy, not in the idea of discretion in and of itself. One must relate governmental discretion to the micro-structure of the firm, and only that discretion which favors employees would systematically demean public ownership. Discretion in itself fails to explain diffuse ownership.

2. Trust. — One might try to build a similar thesis with trust substituting for good law as the necessary corporate foundation. In "high" trust societies, majority stockholders will not harshly degrade minority stockholders position, because of the society's norms. In Scandinavian societies trust is high, and citizens who leave their unlocked bicycles on the street can be sure that the bicycles will be there when they return. Minority stockholders in a high-trust nation who leave their stock "unlocked" and unprotected by formal legal institutions could be sure that they could obtain pro rata value on their stock.[127]

The empirical difficulty with this argument can be seen by examining Tables I and II:[128] Despite their high trust, the Scandinavian societies —Denmark, Finland, Norway and Sweden—are *not* high in diffuse

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[127] Cf. Paul J. Zak & Stephen Knack, Trust and Growth 1-3, 18 (Clarement working paper, Sept. 10, 1998) (building on Douglass C. North, Institutions, Institutional Change and Economic Performance (1990)); cf. Francis Fukuyama, Trust: The Social Virtues and the Creation of Prosperity (1995) (trust necessary); Mark Granovetter, Economic Action and Social Structure: The Problem of Embeddedness, 91 Am. J. Sociology 481 (1985); Russell Hardin, Trust (1998) (trust insufficient, law and enforcement necessary); Robert D. Putnam, Making Democracy Work: Civic Traditions in Modern Italy (1993).

[128] See supra p. 21

ownership.[129] These nations are strong or moderate social democracies, however, and that probably best explains the resulting ownership structure. This result is unsurprising: Even if high trust makes minority stockholders no more afraid of majority stockholders in Scandinavia than they are of bicycle thieves, Scandinavian stockholders have reason to fear that in their social democracies managers' loyalty to shareholders would be undermined. Despite high trust *between* large and small shareholders, social democracy would fray managers' ties to diffuse owners. Diffuse ownership, hence, is unstable in Scandinavia, and concentrated ownership persists. Indeed, high social trust may correlate closely with the solidarity of a social democracy.

The lack of correlation between high-trust nations and diffuse ownership undermines the law-driven hypothesis and emphasizes why "good" corporate law is probably at least as derivative as it is causal. Law and trust substitute for one another.[130] If trust is high and a hand-shake good enough, law is unnecessary; if law is good, trust is a lower cost way of bringing about what good law would do.[131] Since high trust does not yield diffuse ownership, despite that investors should trust blockholders in the high-trust nations, then diffuse ownership probably does not depend primarily on laws protecting minority stockholders, but on something else; by default the social democracy thesis is strengthened.

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[129] Even if we correct for their smaller economies, the result does not change, as the Appendix shows. If we correct for size, the Scandinavian nations move toward the middle of the diffuse ownership list; if we drop the concentration cutoff from 20% to 10%, the Scandinavian nations become the *leading* diffusely-owned firms. In neither case are the high-trust nations also high diffuse-ownership nations. Once again, social democracy, not trust, best explains the data.

[130] Cf. Russell Hardin, Trust and Society 31 (working paper, N.Y.U.) (1998).

[131] Some nations have good investor protection law and trust, but still lack diffuse ownership. Zak & Knack, supra note 127, at 22; Rafael La Porta et al., Law and Finance, 106 J. Pol. Econ. 1113, 1136-37 (1998). Sweden has good law, good accounting, and high trust, but is still *low* on diffuse ownership, thus posing a counter-example to the basic law-driven thesis. Trust and good law are not enough. The premium for voting shares over non-voting shares is low in Sweden, about that of the U.S. See Luigi Zingales, What Determines the Value of Corporate Votes? Q.J. Econ., Nov. 1995, at 1047, 1059. Presumably good law, or high trust, prevents controllers from diverting too much value to themselves, making the vote not a source of private value. But Swedish ownership is not diffuse. It is, however, a strong social democracy, the nation that, in 1920, had the world's first elected socialist government. Przeworski, supra note 2, at 835.

High social trust is a good norm for a nation to have. It may be needed for commerce; it raises the quality of life, commercial and otherwise. But high social trust, like technical corporate law, just is not a primary determinant of diffuse ownership, of the separation of ownership from control, and of the rise of the public firm.

C. Technological Change

As technology evolves, the underlying organizational forms may evolve as well. Movement away from heavy smoke-stack manufacturing toward rapidly moving service industries could affect corporate governance in two ways. First, the new industries may be less susceptible to the social and economic conflicts that raise agency costs. Second, further empowering employees in service industries may be efficient from capital's perspective. Even if agency problems arise due to continuing conflict there, these agency problems may not be as costly to invested capital because the ratio of invested capital to human capital is often less in the new service and high-tech industries than in the old heavy manufacturing industries. Stock options for managers *and* employees are common in high-tech firms, where commitment and human capital is important. When technology renders the old-style smoke-stack factory less important, social conflict cannot lead to it being expropriated. More simply, when a firm is expanding, fewer conflicts irritate the relationship between social democracy and the public firm.[132]

Some firms that have piggy-backed on American securities markets, thereby binding them to American securities rules even if not yet to American internal corporate rules, are high-tech companies. For them, not only is securities distribution and following from analysts better in the U.S., but, because they have a high ratio of human to physical capital, they are less likely to be affected by their nation's social democracies than other firms. Others have piggy-backed, but retained block ownership even after selling stock in the U.S.

V. Political Preconditions in the United States

While I have thus far primarily analyzed the political realities of continental Europe, I need not remind the reader that this Article is really

[132] Cf. Stewart Fleming, The Neuer Markt's Wild Rise, Inst. Inv., Apr. 1999, at 76, 77, 80 (the new listings in Germany's Neuer Market are expanding, disproportionately high tech—and presumably high human capital—firms that are adding jobs).

about the United States. The American Berle-Means firm is usually seen as an economic institution that evolved because of the technological and financial problems of large size, learned how to feed its concomitant voracious demand for capital, and developed means to control the loosely-supervised managerial agents at the top of the firm.

But substantial political prerequisites existed to the rise, evolution, and business domination of the large public firm. Economic-based social conflict in the U.S. was lower than it was elsewhere. With conflict lower, shareholders could remove themselves from overseeing the firm day-to-day without fearing that managers would be "captured" by social democratic pressures. In time, ways to tie managers to shareholders arose, and they could not easily have arisen were the United States more of a social democracy.

Conclusion: Political Preconditions to Separating Ownership from Control

The American-style public corporation is a fragile contraption, filled with contradictions, one easy to destabilize and destroy. It dominates American business, due to its ability to agglomerate capital and efficiently spread private risk, but needs multiple preconditions to arise, survive, and prosper. One powerful precondition is the institutional ability to control agency costs, an ability that a social democracy reduces, or destroys.

True, the benefits with which the public firm is associated—innovation, competition, and high tech, for example—might be obtained without Berle-Means. The American-centered view that the public firm is the pinnacle of corporate development may be incorrect. Innovation, competition, and efficient production can be reached in different organizations. Nations that deny themselves one organizational form do not condemn themselves to economic backwardness, but leave themselves without one tool in the organizational toolkit. (And, similarly, nations that overly fragment institutional shareholding and financial voice inside the corporate boardroom deny themselves a different tool.)

Moreover, this is hardly a reason to condemn social democracies. What gets lost in shareholder tools may be gained on the shop floor; net efficiency effects may be zero. And the solidarity and equality in these nations may make more citizens happier, and those societies may in the long run be more stable and productive. Many European players, even managerial players, believe this to be so.[133] Citizens in nations with a yearning for stability, perhaps one created by gloomy destructive histories, may get special value from the stability of a social democracy.

But productivity effects and the overall value of a social democracy are not the principal lines of thought here. The key point here is that creating many public firms and deep securities markets in social democracies is more than just a technical problem of creating the right legal institutions, but a problem that goes to the core of the social and political organization of that society. As such, reformers will find technical solutions frustrating or impossible to implement; and even if implemented, the technical reforms will have little effect unless and until the underlying political reality changes.

Capital markets and institutions, managerial markets and institutions, and labor markets and institutions inter-relate. Some types fit well together, complementing one other, and some do not. Politics can determine one type of the three and thereby indirectly determine the other two, because sometimes only a restricted set of the others will fit the one that politics determined. America's historical antipathy to private institutional power over-emphasized one kind of capital market, and thereby affected the managerial institutions of the public firm.[134] European politics affected labor institutions and these in turn affected managerial institutions and capital structure. Had American labor institutions differed—had the U.S. been more of a social democracy—the public firm would have had rougher going in the U.S. and may have been a minor, not a major American business institution.

So, to restate, the fewer public firms and shallower security markets in France, Germany, and the rest of continental Europe have often been seen as technical results, as deriving from the inability to build the needed *institutional* prerequisites. Accounting needs to be transparent. Culture that leads the upper middle class in Europe to avoid owning stocks and that calls forth too few entrepreneurs is blamed. Securities laws need re-vamping; insider traders must be jailed when discovered. And, most recently, analysts have discovered minority stockholder protection as a fundamental prerequisite to public firms and deep securities markets.

Some of these technical problems are hardly insurmountable. France and Germany have built good bureaucracies, staffed by capable and motivated professionals. If securities laws determine the differences in

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[133] See Albert, supra note 24.

[134] Roe, supra note 81, at xiii-xvi, 283-87.

securities markets, then one wonders why and how "technical" law could be the difference here, because France and Germany can be better than the United States at drafting and implementing comprehensive statutory schemes and then building government agencies to enforce them.

The technical barriers are not to be ignored, but can easily be exaggerated into bedrock causes, when they may mostly be results, not foundations. Often firms can solve the technical problems themselves. They can adopt world-wide accounting standards; they can even criminalize violations by selling their securities in the United States. They can adopt American corporate law by selling securities through a Delaware holding company. They can build ownership structure rules into their charter, something that usually requires only a minimum of background contract enforcement to be effective.

Many key rules that control dominant stockholders can be constructed out of contract law. While societies like Russia that *utterly* fail to enforce contract cannot build these corporate institutions, analysts who extrapolate the converse—that France, Germany, and Scandinavia must also have bad law—may be blinded by the Russian experience. These nations enforce contract no worse than the U.S.[135]

If they do not build the corporate protections often, or at all, other explanations must explain their inaction. *The demand for those institutions might be low, because other institutions—namely, the social democracy itself —render public firms less valuable to diffuse shareholders.* When blocks persist, one cannot tell *a priori* whether distant stockholders fear dominant stockholders or fear high agency costs in a Berle-Means firm. If they fear high managerial agency costs, blockholding would tend to persist as that nation's best way to control agency costs.

This result is not merely technical, arising just from the accidents of which technical institutions a society has built. And, hence, the solutions are not purely technical either. The result maps back to a society's political condition: Social democracies will raise the agency costs to shareholders in the Berle-Means public firm. They will exacerbate managerial tendencies to expand unprofitably, to avoid risk at all costs, and to avoid biting the bullet and forcing organizational change when markets and technologies have shifted. In each case incumbent employees will tend to prefer that these changes not

[135] Bad law deters public firms, but that need not imply that wherever public firms are absent, there must be bad law.

go forward, incumbent employees will have a strong political voice in social democracies, and managers will have a rougher time bringing about organizational change in the social democracies. Oftentimes they will not want to bring about these organizational changes anyway.

Aligning managers with shareholders is harder in social democracies than elsewhere: owners dislike transparent accounting, which would give employees more information than many owners would be happy with their employees having, but transparent accounting is necessary for distant securities holders. Hence, the demand for accounting transparency will be weaker in the social democracies and, as long as accounting is opaque, close owners (who can privately extract information from the firm and its managers) will persist. Shareholder wealth maximization norms will be weaker in the social democracies. The strong control mechanisms of the hostile takeover and publicly-known incentive compensation will be harder or impossible to implement in the social democracies.

The political theory here is that social democracies wedge open the gap between shareholders and managers in public firms, by raising agency costs higher and reducing the efficacy of the techniques that would control them. This wedge has been small in the United States, and we have thereby uncovered the critical precondition to ownership separating from control and, hence, of the rise and persistence of the dominant form of business organization in the United States, namely the historical absence of a strong social democracy.

Appendix

Table VII
Size-adjusted diffuse ownership

Percentage of widely-held firms among first 20 firms with capitalization above $500 million, with a 20%+ blockholder making the firm not widely-held	
Austria	.00
Italy	.00
France	.00
Germany	.10
Netherlands	.10
Sweden	.10
Belgium	.20
Finland	.20
Norway	.20
Australia	.30
Denmark	.30
Japan	.30
Switzerland	.50
Canada	.60
United Kingdom	.60
United States	.90

Table VIII
Widely-held firms using lower 10% blockholder cutoff

Percentage of widely-held firms among 20 largest firms, with a 10%+ blockholder making the firm not widely-held	
Belgium	.00
Sweden	.00
Austria	.05
Norway	.05
Denmark	.10
Finland	.15
Italy	.15
Netherlands	.30
France	.30
Germany	.35
Canada	.50
Japan	.50
Switzerland	.50
Australia	.55
United States	.80
United Kingdom	.90

Table IX
Regressing politics on size-adjusted and lower-cutoff diffusion
Regressions on Tables VII, VIII, and I

	Regression coefficient (t-statistic)	R-squared
10% cutoff v. Recent political rating (Table VIII v. Table I)	0.32 (3.62*)	0.77
20% cutoff v. Recent political rating (Table VII v. Table I)	0.28 (3.23*)	0.72

* Significant at .005 level (less than 1 chance out of 200 of relationship being random).

Table X
Inequality and Diffuse Ownership

Country	GINI	Percentage Widely Held Corps.
Austria	23.1	.05
Denmark	24.7	.40
Belgium	25.0	.05
Sweden	25.0	.25
Norway	25.2	.25
Finland	25.6	.35
Germany	28.1	.50
Italy	31.2	.20
Netherlands	31.5	.30
Canada	31.5	.60
United Kingdom	32.6	1.00
France	32.7	.60
Australia	33.7	.65
Japan	35.0	.60
Switzerland	36.1	.90
United States	40.1	.80

Source: The GINI coefficients came from Organisation de Coopération et Développement Economiques, Coup d'Oeil sur les Economies de l'OCDE—Indicateurs structurels 15 (1996); concentration data comes, as before, from La Porta, et al., supra note 131.

The GINI coefficient measures income inequality, with a higher GINI indicating higher inequality.

Table XI
Regressing Inequality on Diffuse Ownership (from Table X)

Regression coefficient (t-statistic)	R-squared
0.04 (4.43*)	0.88

* Significant at the .0005 level (less than one chance out of 2000 of relationship being random).