CHAPTER 1

Introduction and Summary Argument

Enron, WorldCom, Tyco, Adelphia, Ahold (a Dutch firm), Hollinger (Canadian), Vivendi (French), Parmalat (Italian)—these names have long been staples of the *Financial Times* and *Wall Street Journal*, but more recently they have become scandalous and exotic fare on news dailies and TV networks. Since the Enron scandal began in the fall of 2001, these firms, their bankruptcies, and their miscreant executives have become "above the fold" headlines and evening news clips.[1]

In addition to providing entertainment, these examples of financial failure have graphically demonstrated that there is, in fact, what some delicately refer to as a "corporate governance problem." Scholars and media mavens alike frequently dismissed the corporate implosions that followed in the wake of the financial crises in the mid-1990s—mostly in Latin America and developing Asia—as a regional problem specific to the "crony capitalism" of developing regions. By the turn of the millennium, it became clear the problem was more widespread. Scandals of one kind or another were occurring around the world. At first, people saw Enron as a "one-off" case, a singular event caused by unscrupulous or incompetent people and requiring no special response.[2] As more scandals emerged, however, it became clear that something deeper was at work.

This book is not about these scandals, but about the underlying structures of corporate accountability. We will not try to say why any specific individual abused trust, but rather are interested in the variance among systems of corporate governance around the world. There was a "corporate governance problem" long before Enron and Parmalat. Fiske and Gould were famous nineteenth-century American examples of stock manipulation, with counterparts around the world. Their behavior led to efforts, private and public, to protect investors. Those efforts are the central concern of this book.

Corporate governance is about power and responsibility. It is the structure of power within each firm that determines who allocates money: who gets the cash flow, who allocates jobs, who decides on research and development, on mergers

[1] Media in the West focused on these firms, but Asia and Latin America witnessed a parallel series of high-profile corporate governance scandals, including Korea's SK Corp and LG Card debacles; China's Shanghai Land and Far East Pharmaceutical; Hong Kong–listed CNOOC Finance and China Life; Thailand's Thai Petrochemical Industry; Indonesia's Asian Pulp and Paper; an apparently endless series of Japanese bank abuses; Mexico's TV Azteca; Chile's Endesa/Enersis squabble; and Brazil's COPEL case.

[2] In addition to news stories, this observation is based on comments made over the fall and winter of 2001–2 by participants at a Roundtable on Corporate Governance, organized by the authors of this book at the Council on Foreign Relations, leading to publication of Peter A. Gourevitch and James P. Shinn, *How Shareholder Reforms Can Pay Foreign Policy Dividends* (New York: Council on Foreign Relations, 2002).

and acquisitions, on hiring and firing CEOs, on subcontracting to suppliers, on distributing dividends or buying back shares or investing in new equipment. Corporate governance is also about accountability: who takes the blame for corruption, misuse of funds, or poor performance.

Corporate governance systems reflect public policy choices. Countries pass laws that shape incentives, which in turn shape governance systems. Some countries have rigorous prohibitions on insider trading, vigorous markets for control, strong protection of minority shareholders (rules on accounting, corporate boards, securities), and effective rules for product-market competition and antitrust. These countries have diffuse patterns of share ownership and managerial supervision through boards elected by their shareholders. Other countries encourage blockholding by allowing pyramid leveraging and cross-shareholding, restricting markets for control, limiting competition, and offering weak protection to minority shareholders.

Such different regulatory policies concerning corporate governance turn on political differences among countries—on the interest groups that press for one set of rules or another and on the political institutions that aggregate preferences to produce policies. This book is about choices of corporate governance in countries around the globe. We make extensive reference to the United States, where the give-and-take of interest groups as they press their preferred arrangements for corporate accountability has been particularly visible. American political processes produced the Sarbanes-Oxley bill of 2002, the most extensive U.S. reform of rules on corporate governance in several decades.

Indeed, politics explains the great U.S. "reversal" in corporate governance. In the late nineteenth century, the U.S. system resembled those of Europe: large "trusts" or oligopolies were controlled by shareholder blocks in the hands of individuals and banks; minority shareholder protection was weak, insider trader scandals common. Then laws were passed: the Sherman Antitrust Act in 1890, several laws following the 1905 Armstrong Commission on the insurance industry, the Glass-Steagall Act on banking in 1933, the Securities and Exchange Act of 1934, and now Sarbanes-Oxley of 2002. It is this legislation, regulatory structure, and their enforcement that changed corporate governance in the United States.

In the United States, *interest groups* fought over these laws and regulations: owners; investors as outsiders and investors as insiders; workers as employees and workers as pension fund holders; managers of various kinds; the so-called reputational intermediaries consisting of accountants, lawyers, bond-rating agencies; and institutional investors. These groups fought through *political institutions* whose structure influenced the outcome: the separation of power between the U.S. Congress and the presidency, federalism, political parties, and electoral laws.

These elements of politics—interests, institutions, and political conflict—are in play all over the world. In Korea greater democratization in the 1990s broke the link between the big firms (*chaebols*) and the authoritarian government, leading to rules for greater transparency and accountability in corporate governance, backed by a coalition that included labor, previously excluded businesses, and regional reformers. In Germany, the various political parties have been battling over legislation that would create markets for control, shareholder rights, and transparency; contrary to most expectations, it is labor and the Social Democrats who are often on the side of the external investors, while the conservative Christian Democrats defend the established insider system preferred by managers and inside blockholders. In Italy, the Parmalat scandal, in France, the Vivendi controversy, and in the Netherlands, the Ahold case have all pushed issues of governance to the fore. The financial crisis of 1997 exposed weaknesses in governance mechanisms for several countries in Asia, particularly in Korea, Thailand, Indonesia, and Malaysia. In Europe, disagreement on takeover legislation and a variety of other measures has slowed development of European Community–wide policies on corporate governance.

Why Fight about Corporate Governance?

That corporate governance provokes political debate should not surprise us. Corporate governance—the authority structure of a firm—lies at the heart of the most important issues of society. That authority structure decides who has claim to the cash flow of the firm, who has a say in its strategy and its allocation of resources. As such, corporate governance affects the creation of wealth and its distribution into different pockets. It shapes the efficiency of firms, the stability of employment, the fortunes of suppliers and distributors, the portfolios of pensioners and retirees, the endowments of orphanages and hospitals, the claims of the rich and the poor. It creates the temptations for cheating and the rewards for honesty, inside the firm and more generally in the body politic. Corporate governance influences social mobility, stability, and fluidity: the openness of economic systems to new entrants and outsiders from established social structures, and the rewards to entrepreneurial initiative. It shapes the incentives firms have to invest in their labor force; thus it intersects with education and training systems, and with social welfare, health, and retirement plans. Corporate governance interacts with hostile takeovers, antitrust, economic competition, international trade disputes, and trade unions. It structures pension systems, social security, and retirement plans.

It is no wonder, then, that corporate governance provokes conflict. Anything so important will be fought over. Anything that shapes wealth, opportunities, stability, and corruption is sure to attract the concerns of the powerful and provoke the anxiety of the weak. Everyone has a stake in the corporate governance system, and everyone has an interest in how it is structured.

We believe that, like other decisions about authority, corporate governance structures are fundamentally the result of political decisions. Corporate governance systems reflect policy choices. They are shaped by a mixture of laws, rules, regulations, and the degree of their enforcement. These laws define the obligations of managers, the rights and duties of owners, the claims of shareholders, and the powers of boards. Researchers often group these rules under the label of *corporate governance law*, dealing largely with the composition and obligations of the board, separating these from *securities law*, dealing with shareholding processes. We use a broader label, increasingly recognized as more comprehensive, *minority shareholder protections*, covering issues of accounting, takeovers, reporting, and control issues—all the legal factors that control a firm's cash flow.

We take our concerns a step farther than the firm itself. A firm's authority system is also shaped by processes outside what are normally called governance rules within the firm. Labor market regulations shape employees' job protection (how easy or difficult it is to fire workers): strong job protection gives workers substantial influence on how the firm is run. Other rules shape the connection of firms to suppliers and distributors, defining the claims and obligations of each.[3] Still other rules define antitrust, banking and finance, competition from other countries and within each country, and pension plans, all of which can have an impact on corporate governance.[4]

Nor is it enough to know the "law on the books." Much depends on whether and how these laws are enforced. Many countries have extensive codes and shareholder protections—but these are not enforced. Or, if enforced, their interpretation can alter their meaning substantially. The actual application of law turns, again, on politics and choices.

That corporate governance reflects political choices is not the standard perspective. Most treatments look at law, economics, and contractual issues between parties as if they were separate from politics. That is not our view. Law and economic policies have an impact on what happens, but the content of those laws, policies, and regulations needs to be explained. For example, some countries forbid insider trading, allow hostile takeovers, and compel substantial reporting of information to shareholders (the United States has done all of these for many years), while other countries do not. Some countries have substantial cross-shareholding among firms (Japan), or vertical pyramid control (Chile), while other countries forbid these practices. Germany requires firms to have union representatives on the board; the United Kingdom and the United States do not.

Great Variance and the "Great Reversals"

Countries vary substantially in the way they organize authority in the firm. To simplify, we can contrast two models: an external, diffuse *shareholder* model and an internal concentrated *blockholder* model. In the external or diffuse shareholder

[3] In this respect corporate governance resembles other forms of "nested authority," where relationships within a unit are influenced by the larger structures in which they operate. See Miles Kahler and David Lake, eds., *Governance in a Global Economy: Political Authority in Transition* (Princeton: Princeton University Press, 2003).

[4] Mark Roe has been a leader in asserting the importance of politics in shaping corporate governance. His most recent book, *Political Determinants of Corporate Governance: Political Context, Corporate Impact* (New York: Oxford University Press, 2003), stresses the limits of corporate law in fully explaining the patterns.

model, managers are supervised by a board of directors elected by shareholders; the board members hold relatively small portions of the total stock, but their vote is required on major decisions, and they are supposed to discipline or reward the managers. Rewards of stock options are one way to align managers with the many diffuse shareholders—in theory. Managerial performance is assessed by information provided through "reputational intermediaries" such as accountants and market analysts; the market price of the stock provides an ongoing evaluation of the company's prospects and its managers' competence. An active market for corporate control, allowing hostile takeovers and inhibiting barriers like poison pills, provides an important tool for punishing managerial incompetence and neglect by the board. The United States has moved the farthest down the path toward this system, famously described by Berle and Means as the separation of ownership and control.[5]

By contrast, the blockholder model tightly links ownership and control. Managers are supervised by "insiders" (concentrated blockholders), with little formal protection of the outsiders, or minority shareholders. This model disciplines managers through direct supervision and intervention by insider owners who control large blocks of shares. The blockholder approach has several variants. In one version, large shareholder blocks are held by financial institutions, banks, or other firms. The family or ethnic network is another variant, in which personal or group ties are used to control managers. Yet another form of blockholding is the state ownership model, where public authorities use a variety of instruments to supervise firms. For the blockholder category generally, some influential theorists, such as Ronald Dore, use the label *stakeholder model* to convey the range of groups besides shareholders with claims on the firm; we reserve this term to consider the politics of choosing the form, rather than the governance system itself.[6]

Most of the world operates through the blockholder model. It exists in Germany and Japan, in most of continental Europe, and, indeed, in a variety of forms throughout Latin America and Asia.[7] The diffuse shareholder model found in the United States is relatively unusual. And even in the United States, it is rather recent in the evolution of organizational forms. There is much talk in the business press and among researchers about change around the world, about convergence toward the American model. We need to consider, then, what causes governance systems and what causes them to change.

What explains this difference among countries and over time? It is only recently that observers have come fully to appreciate how great the variance is. In the United States at least, it was thought that the Berle-Means separation—the American model—was the inevitable path for all countries. This was how markets worked, it was argued, and as all countries engaged in the market, they

[5] Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Commerce Clearing House, 1932).

[6] Ronald Dore, *Stock Market Capitalism, Welfare Capitalism: Japan and Germany versus the Anglo-Saxons* (New York: Oxford University Press, 2000).

[7] Though technically Japan has diffuse ownership, cross-shareholding makes it function like a blockholding system. See discussion of Japan in Dore 2000.

too would look this way. So long as the U.S. economy seemed to be the world's most dynamic, this attitude prevailed, among pundits and (most) scholars alike.

Then, in the 1980s, the U.S. economy stumbled. Japan and Germany grew rapidly, exports penetrated the United States, there was talk of the "rust belt" and economic decline. "American's Failing Capitalist System" was the title of a *Harvard Business Review* essay by Michael Porter, which indicted (among other alleged sins) the U.S. corporate governance system as a factor in this "decline."[8]

Much was written about the German and the Japanese models, and many labels were generated for these models with their allegedly superior institutional endowment: "Rhenish capitalism," "coordinated market economy," "regulatory market," "social market," "stakeholder capitalism." Michel Albert's *Capitalism versus Capitalism* pointed out to the public that key debates in comparative political economy were not about state versus market, but among different forms of market economies, and that choices had to be made. France, he argued, had to choose between the Rhenish model of Germany and the neoliberal model of the United States and the United Kingdom.[9]

Then the pendulum swung back. By the late 1990s, the U.S. economy was booming, while Japan and Germany stagnated. The U.S. model re-acquired both political and intellectual status. This time the U.S. model would indeed triumph, wrote many observers, and the world would conform to its practices, including corporate governance. Two prominent specialists even proclaimed "The End of History for Corporate Law."[10] And then, yet another shift: Enron set off the chain reaction of governance scandals with which we began this book, revealing structural flaws in corporate governance in so many countries that triumphalism with regard to the virtues of any corporate model—U.S., European, or Japanese—appeared increasingly silly.

When we compare countries, we do not find the same corporate governance system in each. Even with a single country, a sense of history is useful, for we rarely find consistency over time. The United States, so strongly identified with the Berle-Means pattern now, was not always thus. In the late nineteenth century, patterns of ownership of large firms looked far more like Germany than they do now. U.S. firms began with concentrated inside owners, the blockholding model, as have most firms around the world. The United States then began to create shareholder protections through listing requirements on stock exchanges.

[8] Michael Porter, "Capital Disadvantage: America's Failing Capital System," *Harvard Business Review* 72 (1992): 65–83. Porter was a leader in encouraging comparative rather than U.S.-centric study of countries and firm strategy.

[9] See Michel Albert, *Capitalism versus Capitalism: How America's Obsession with Individual Achievement and Short-Term Profit Has Led to the Brink of Collapse* (New York: Four Walls Eight Windows, 1993); Masahiko Aoki, *Information, Corporate Governance, and Institutional Diversity: Competitiveness in Japan, the United States, and the Transitional Economies* (New York: Oxford University Press, 2001); Peter A. Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (New York: Oxford University Press, 2001); and Dore 2000.

[10] See Henry Hansmann and Reinier Kraakman, "The End of History for Corporate Law," *Georgetown Law Journal* 89 (2000): 439–67.

Legislation, stimulated in part by earlier scandals, produced financial separation of firms from insurance companies and banks. Antitrust rules, securities regulation, and accounting rules institutionalized these practices to generate what we now call the Anglo-American model.

The pattern we call American was not given as part of the natural contours of the North American tectonic plate. It was created by people. It came out of specific, identifiable decisions, made over time, in the various pieces of legislation we noted earlier, from the Sherman Antitrust Act of 1890 to Sarbanes-Oxley of 2002.

These "great reversals," to use the phrase of Rajan and Zingales, belie the notion found in the literature that governance patterns are "hard-wired," as the most prominent theory in the law-and-economics literature—the "legal family school"—strongly suggests.[11] Countries have long been classified according to their legal system of either "common" or "civil" law; case law has been associated with the United Kingdom and its colonial descendants, and civil law with France and its colonial or cultural descendants. La Porta, López-de-Silanes, Shleifer, and Vishny did important research on the differences in corporate law and in securities law, and found that they correlated with the degree of ownership concentration or diffusion, thus with corporate governance practices.[12] They then found that these practices, in turn, correlated with the distinction between common and civil law, the former producing the diffusion model, the latter producing blockholding. This analysis became thereby a widely cited theory of variance: country legal families shape corporate governance practice.

That theory, however, does not explain change: countries have shifted over time. Rajan and Zingales show that France and Japan had vibrant, diffused securities markets before World War I. After the war, policy and law changed: political factors—stronger trade unions, protectionist lobbies, "rent-seeking" business groups, banks—all pushed for a system that regulated markets and favored insider control. Corporate governance in the two countries became more blockholder oriented. At the same time, the United States went the other way, toward more diffuse shareholder patterns and stronger instruments of minority shareholder control.

Thus, corporate governance systems vary among countries around the world, and over time, corporate governance systems within countries change. We need robust, rigorous explanations of these changes, rather than shallow triumphalism (of any flavor) until the next swing of the pendulum. These explanations have to look at variables that themselves change: if corporate governance outcomes are the dependent variable, something in the independent variables must have produced the change. The decisive independent variables cannot therefore be "constants"

[11] See Raghuram Rajan and Luigi Zingales, "The Great Reversals: The Politics of Financial Development in the Twentieth Century," *Journal of Financial Economics* 69 (2003): 5–50.

[12] See Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer, and Robert Vishny, "Legal Determinants of External Finance," *Journal of Finance* 52 (1997): 1131–50; "Law and Finance," *Journal of Political Economy* 106 (1998): 1113–55; "Investor Protection and Corporate Governance," *Journal of Financial Economics* 58 (2000): 3–27; and "Investor Protection and Corporate Valuation," *Journal of Finance* 57 (2002): 1147–70.

in a country—for example, its legal family, something created centuries ago, which rarely changes and only very slowly. It cannot be the enduring "cultural" components of a country, its value systems, or habits, which define its essence, as these two also change very slowly, and cannot account for variance within the culture's practices. Thus change from one period to another, such as France from the 1940s to the present, cannot be explained by the enduring and continuous features of French civilization. Instead, in this book we seek an explanation of both static and dynamic variation in governance among countries, rooted in economic preferences and political institutions—in short, in politics.

Corporate governance practices reflect law and regulation. Laws express the outcome of political processes—a broad political bargain among the major players contesting a variety of policies that influence incentives, which in turn produce corporate governance outcomes. Our causal model looks at *preferences*—at interest groups that advocate policies that promote their goals—and at *political institutions*—the machinery that refracts the preferences and that aggregates them into policy outcomes.

Who are the players that produce these bargains? We start with the law-and-economics tradition, which focuses on owners and managers. These are key players in the problems of authority within the firm. They face the problem of the "incomplete contract," that is, how to handle the impossibility of specifying all future contingencies with a contract. This uncertainty creates a risk of moral hazard, the ability of an agent (here, the manager) to act against the goals of the principals (here, the owners). Owners need managers, but how do they know the managers will not abuse the discretion they are given? At the same time, outside investors seek protection from abuse by insiders. These conflicting goals shape policy preferences about rules. Managers and insider blockholders want autonomy. External investors want protection. The two groups will battle in the private and public spheres over the rules that shape governance of the firm.

To this mix we add workers, the employees of the firm. They are often left out of models of corporate governance, largely because the labor contract is assumed to be complete, fully specifying the conditions that merit either payment of a wage or dismissal. The completeness of the labor contract is contestable and does not at any rate fully cover the power of employees or the need for management and owners to have a well-functioning workforce. Workers have their own concerns about governance: how much of the firm's cash goes to protect job security, the level of pay, working conditions, health benefits, and, increasingly in some countries, the protection of their firm-related pension benefits.

"Owners" (O), "Managers" (M), and "Workers" (W) thus develop alternative preferences for a corporate governance regime. As there is more than one dimension in the preference functions of each group, they can combine in different coalitions. Owners and managers ally to contain workers' demands on wages and job security; workers and managers combine to secure employment and stable wages in the firm; and workers and owners combine to contain managerial agency costs and preserve the security of their investments and pensions, and even jobs. These coalitional alignments of O, M, and W are summarized in table 2.4, and the reasoning behind the preferences, the coalitions, and their consequences is developed in chapter 3.

To get what they want in law and regulation, however, these actors must move disagreements inside the firm out into the public arena. To obtain their preferred corporate governance outcome, they have to win in politics. To do that, they have to mobilize allies outside the firm. Each type of player—owners, managers, workers—has counterparts in society: fellow owners, managers, and workers. To some degree players make their appeal based on some common ground—for example, all workers may be assumed to have a common interest, and all owners a common interest in opposition to workers (see chapter 5). But there may be cleavages within each group and other criteria of attraction across class bounds. Workers in a vigorous export industry may diverge from those in a declining or uncompetitive one or from those in nontradables. They may ally with managers and owners on sectoral rather than class grounds (see chapter 6). Workers with substantial pension holdings may have preferences different from those of workers wholly dependent on PAYGO (pay as you go) public-sector social security. Indeed, we see the growth of pension funds as a substantial driver of new coalitional possibilities, drawing worker-based pension funds into alliance with minority shareholder groups against insider managers and blockholders. This approach is contrary to most scholarly treatments, which see workers in direct opposition to outside investors. In order to convey these relationships we provide an analysis of the structure of pension fund systems (see chapter 7). Blockholders with substantial assets in a specific firm may think differently than owners with dispersed, diffuse shareholdings. We therefore will need to make our model more complex, at the expense of parsimony.

As workers, owners, and managers turn to society, they find a complex structure. Many voters and interest groups interact with the firm but are not part of it—indeed, vertical "disintegration" is so extensive that more and more relationships are enacted across firms rather than within them. Firms have many relationships "upstream" and "downstream," with suppliers above, distributors below. They are located in cities and districts that care about the success of particular firms. Lawyers, accountants, bond-rating agencies, banks, and financial intermediaries all make a living dealing with firms.

These groups thus have a double interest: in one guise, they identify with the firm that gives them business. In another, they are a group unto themselves, a caste, or a corps within the system, with its own sectoral interests, interest groups, and concerns. Thus the accounting industry has its own lobbies that defend goals in the system, to preserve the profitability of the industry as a whole or of specific firms. The same can be said for the other groups—the so-called reputational intermediaries that provide information to investors, shaping the financial image of the firm.[13]

Some researchers call these many groups with an interest in the firm "stakeholders," actors with a stake in the firm. The label contrasts with the "shareholder"

[13] See Timothy J. Sinclair, *The New Masters of Capital: American Bond Rating Agencies and the Politics of Creditworthiness* (Ithaca, N.Y.: Cornell University Press, 2004); and "Global Monitor: Bond Rating Agencies," *New Political Economy* 8 (2003): 147–61.

approach, where a fiduciary hierarchy gives a clear primacy to shareholders and their agents, managers. The distinction is both descriptive and normative. For our purposes, all society has some voice in the firm because the rules are made by a political system in which the "citizens" of society are far more numerous than the "citizens" of the firm. The players in the firm, as they turn to politics to get the regulations they prefer, have to appeal to a broad set of external stakeholders. Unraveling the politics of regulation obligates us to look at instruments of linkage and aggregation, methods of combining citizens, voters, and interests into a political process.

For this we look at political institutions, which aggregate preferences into a process that produces outcomes. These include the formal constitutional institutions of a political system, such as legislative-executive relations, electoral laws, and federalism, and the private ones, such as political parties and interest groups. Researchers on a variety of policy issues find that the type of political system influences the content of policy. For example, single-member winner-take-all electoral systems are more likely to generate consumer-oriented policies, with more competition and lower prices, than are electoral systems with proportional representation or multiseat districts.

We apply these ideas about institutions to corporate governance. Following Arend Lijphart and others, we sort political systems into "majoritarian" and "consensus" types.[14] The first is typified by the U.K. Westminster system, where the government rests on a majority of deputies in the lower house, chosen by single-member plurality districts. The second is typified by Sweden and a number of democracies in continental Europe, where the government relies on a majority of deputies provided by a coalition of political parties chosen through proportional representation.

Majoritarian systems are more likely to generate policies that encourage patterns of diffuse governance, while consensus systems generate blockholding. The effect seems to lie in the greater continuity of policy within consensus systems. This stability reassures actors, who then are more likely to invest in relationship-specific assets, which in turn sustain the more stable governance model of blockholding. Majoritarian systems produce greater swings in policy, which reward investment in more flexible strategies, which sustain the diffuse governance model. These ideas are developed further in chapter 4 and in the country narratives.

Putting the Pieces Together: In Search of a Political Explanation

To sum up: we explain corporate governance outcomes through public policy that is generated by the interaction of interest group preferences and political institutions. Our argument puts great emphasis on public policy and incentives. Corporate governance patterns reflect strategic choices among players seeking to realize some kind

[14] See Arend Lijphart, *Patterns of Democracy: Government Forms and Performance in Thirty-six Countries* (New Haven: Yale University Press, 1999).

of gain: money, security, and so on. Players pick institutional forms according to what suits those preferences. If we know the relevant laws and regulations that structure the incentives, we know what happens in corporate governance.

Which are the relevant laws? We cast this question more broadly than much of the literature. Certainly corporate governance law matters, but so do measures normally excluded from that label, which we group together as *minority shareholder protections* (MSPs). We extend the discussion to include *degrees of coordination* (DoC), the rules that structure markets more broadly, including labor law, antitrust law, price determinations, supplier–distributor relations, all elements of the economy that correlate very highly with patterns of corporate governance. A growing body of research comparing market economies notes the strong covariance of corporate governance with these other arenas of policy. Knowing a country's policies on labor, or welfare, or competition gives us substantial power to predict its laws on diffusion or blockholding and on MSP. In their influential book *The Varieties of Capitalism*, Peter Hall and David Soskice sort advanced industrial countries into two categories: liberal market economies (LMEs) and coordinated market economies (CMEs).[15] Its type of economy influences a country's politics affecting corporate governance. This is the variable we call degrees of coordination, which measures the differences between these two categories of economic systems.

The connection between the DoC variables derived from the varieties-of-capitalism literature and MSP is suggestive. MSP provides some important explanations for corporate governance, but it leaves numerous outliers, and correlations are weak, especially for the CME countries. There we find blockholding even if MSPs are reasonably strong. Sweden and Germany are notable examples. It is possible that the reason lies with the DoC variables: countries that produce high levels of coordination are dampening the incentives for shareholder diffusion.

We find empirically that MSP and the DoC variables influence the pattern of corporate governance. This helps us frame the core question: What explains the provision or lack of high MSP and the provision or lack of policies that favor different DoC? Since MSP and DoC originate in policies, we need to look at the politics that explain the policies.

This is where we turn to interest group preferences, partisan conflicts, and political institutions. We examine interest group and political party variables, following different principles of cleavage: class conflict (left versus right, labor [workers] versus capitalists [investors]); sectoral cleavage (along industry rather than class lines); and a cross-class coalition of labor and minority shareholders against inside blockholders. We also examine the way institutions influence the likely winners of these contests.

This examination gives us a strong picture of the "comparative statics" of the story. It helps us pinpoint whether, at specific moments in time, the corporate governance pattern correlates with specific political variables. This is important, as many of the disagreements over explanations of corporate governance turn on such "point in time" comparisons.

[15] Hall and Soskice, 2001.

The preceding step does not, however, allow us to explore the dynamics of change: What causes movement from one system to another? For that question we need a dynamic comparison, to see if change in the variables leads over time to change in outcomes. A perfect world of information would allow us to perform that analysis, but the data is flawed. For key variables, such as patterns of diffusion, we do not have good historical comparative data. On some dimensions we can show change over time, and we can supplement this evidence with analytic narratives that highlight the interactions at play. Thus we integrate country case narratives into our discussion.

These narratives suggest a complex causal pattern. We doubt a perfect comparative statics will achieve a satisfying explanation. Historical context makes for twists and turns that require something more flexible for causal understanding. Countries make choices at key moments that have long-standing effects. Early and late development à la Gerschenkron, world wars and depression, dictatorship and democracy—all enter the story and need to be integrated into our account.[16]

Our account of incentives makes us skeptical about arguments that predict convergence toward a single model. Much talk about the world economy assumes a single, optimal pattern, a single equilibrium, a unique and perfect way of combining all the ingredients of the economy, so that market competition will force all countries to converge. We are doubtful. The economy is too complex; there are too many ways of putting the pieces together. Convergence assumes a relentless and powerful selection mechanism, clearly rewarding some behaviors as it clearly punishes others.

We don't see this mechanism at work in corporate governance. At times the German and Japanese model has performed very well, at other times not. At times the U.S. model has done superbly, at other times not. Some governance mechanisms do better under certain conditions and worse under others. And conditions change, often faster than the relevant policies, so countries have choices to make. Changing circumstances change the incentives that affect policy—the inducements to change or preserve the rules. Countries may be politically efficient, but not economically so: they respond to political forces pushing for change or preventing it.

Since countries vary in their internal political dynamics—institutions, preferences, parties, and interest groups—their policy outcomes vary. And thus their corporate governance systems will differ. Change may occur, but not necessarily toward convergence on a single model of governance.

Policy Consequences

This book is primarily about the causes of corporate governance systems, rather than a careful study of the consequences. The two are linked in our argumentation:

[16] Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge: Harvard University Press, 1962).

people fight about corporate governance because it affects their lives. Their motives in caring about governance are connected to how it affects their income, their jobs, and their security. We do not, however, provide a systematic exploration of those consequences. We have studied them, but we leave to others exploration of the output in detail.

However, the profound consequences of corporate governance systems have, in our opinion, been insufficiently appreciated. They have not been at the center of investigation in several fields where we think they actually have substantial effects. The literature on comparative capitalisms, for example, was for many years dominated by discussion about the role of the state, comparing the strong state to the weak state. This was an interesting question, but insufficient. The state operates less by picking winners and industrial policy than by structuring the relationships among actors in the market economy, in which the relationships within and between firms is central. The type of state intervention is shaped by the type of governance; it is a prior important choice.

Much literature in comparative capitalism has also looked at social services, the welfare state, income equality, education, labor, and training. All are important topics, but again the role of corporate governance in shaping them has been underplayed (though that is changing). The firm's incentives to invest in worker training, health, and job stability are connected to the governance system: diffuse shareholder firms have limited incentives to invest in workers, while the blockholder system has more.

Trade disputes are rarely studied from the perspective of corporate governance, yet underlying many of these disagreements is the system of relationships structured by governance rules, broadly understood. Japanese firms rely on their network of suppliers, not because they are Japanese but because they are interlinked by cross-shareholding.

Corruption, democracy, and accountable governments both reflect and shape corporate governance patterns. In some countries, blockholding mingles with authoritarianism to mask structures and events. Transparency in politics is needed to sustain transparency in the economy, and each can stimulate the other. The Korean experience, where democratization led to governance reform, is an example that we examine in later chapters. International corruption is also affected by transparency or the lack thereof. For example, money laundering is more difficult when the corporate governance reporting standards are high.

We do not have a strong conviction about the virtues of one system over another. We resist the triumphalism of the Washington consensus that the American way is the only way, and we are skeptical about Japanese or German triumphalism as well. The best version of each type of governance has strong virtues as well as characteristic weaknesses. A stakeholder system can be efficient and honest, a diffusion system can be corrupted and perverted in its operation—and vice versa. We think diversity is a good thing. Each system can provide strengths to the international division of labor. Organizational form complements comparative advantage; having more than one kind can increase productivity. Organizational diversity is inevitable in any case. It behooves us to understand its causes.

Plan of Attack

The book is organized as follows:

Chapter 2 provides a schematic plan for our book and the data on which it relies. It describes the variance of governance patterns around the world, the logic of the argumentation, and the data sources we use to test our explanation of variance.

Chapter 3 examines economic theories of the governance of firms: a technological competition view drawn from Chandler, and the "nexus of contracts" view in law and economics derived from Coase. From this examination we derive the major policy variables that require explanation: the provision or absence of MSP, and the economic policies grouped under DoC.

Chapter 4 lays out the political variables, the preferences of interest groups, and the aggregating mechanisms of political institutions. It evaluates the legal family interpretation associated with La Porta et al., and the economic sociology tradition.

Chapters 5 through 7 examine the three preference group cleavages: workers versus owners and managers in the class conflict cleavage, workers and managers versus owners in the sectoral cleavage, and workers and owners versus managers in the transparency coalition. In each of these chapters we provide detailed case studies of some of the 39 countries whose data we have gathered: Chile, China, France, Korea, Germany, Japan, Malaysia, the Netherlands, Singapore, Sweden, the United Kingdom, and the United States.

Chapter 8, the conclusion, analyzes the patterns we observe in these case studies, the implications of the findings for debates about explanation of governance patterns and about convergence, and issues for further research.

We expect that diverse readers may choose different paths through the book. Many will prefer to read the theoretical setup first before the application and the country cases, and thus will read it in the order presented. Others may explore more effectively by inference from cases and political context, and could move therefore from here to chapters 5–7 and selected country cases, and then move backward. There are many paths through the trees to the forest, or the forest to the trees.