

First draft: March 17<sup>th</sup> 2010  
This draft: October 24<sup>th</sup> 2010  
Preliminary: Comments welcome

# AGENCY PROBLEMS AND THE FATE OF CAPITALISM

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## **Abstract**

Economics has firms maximizing value and people maximizing utility, but firms are run by people. Agency theory concerns the mitigation of this internal contradiction in capitalism. Firms need charters, regulations and laws to restrain those entrusted with their governance, just as economies need constitutions and independent judiciaries to restrain those entrusted with government. Agency problems distort capital allocation if corporate insiders are inefficiently selected or incentivized, and this hampers economic growth absent a legal system with appropriate constraints. However, political economy problems and agency problems in corporations may reinforce each other, compromising the quality of both corporate governance and government.

**Keywords: PRINCIPAL AGENT PROBLEM, CORPORATE GOVERNANCE, ECONOMIC HISTORY, POLITICAL ECONOMY, AUSTRIAN SCHOOL**

**JEL Codes: P1, B53 G28 G34 N20 P12**

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## 1. Introduction

Neoclassical economics presents “capitalism” as a system where multitudes of firms compete to offer customers the best prices. To many, especially outside America and Britain, “capitalism” is a system where a handful of old-moneys families run the economy – often badly. The economists marvel at the others’ credulity for conspiracy theories, while the others marvel at economists’ naivety about the “real world”. Close inspection of corporate governance in different countries suggests that each side will take the other seriously. Capitalism has genuinely different forms in different countries, and these reflect fundamental differences in the distributions of corporate and political control.

Neoclassical economics readily allows that who controls a country’s government matters, but traditionally takes firms as profit maximizing black boxes and capital as a return-generating substance that Samuelson dubbed *shmoo*. Yet who controls firms, and their capital, matters (Berle and Means 1932). How microeconomics can incorporate this insight is the core issue of agency theory (Jensen and Meckling 1976).

Running a business requires scarce talent, and competition among potential leaders ideally assigns corporate control to the most able. Adam Smith (1762) posits that business success requires an empathic ability to predict potential customers’ desires. Hayek (1941, c. 25, p. 335) stresses the importance of exceptional foresight; Knight (1921 c. 9 §3.9.7) stresses the rarity of rational decision-making ability; and Schumpeter (1912) sees uniquely creative innovators building new corporations that destroy old ones, and thereby earning the wrath of all who preferred the status quo.

Somewhat more cynically, and more in line with the recent corporate governance literature, Adam Smith (1776, bk. 5, c. 1, pt. 3, art. 1) holds that corporate directors “seldom pretend to understand anything of the business of the company.” Keynes (1936, c. 12, §5) concurs with Smith, Hayek, Knight, and Schumpeter that “the social purpose of skilled investment is to defeat the dark forces of time and ignorance which envelop our future”, he despairs that this is beyond the ability of corporate executives, whose decisions he attributes to behavioral “animal spirits” (c. 12, §7). Mueller (1992) thus advocates a broadly behavioral approach to modeling managerial decision-making. Brandeis (1914) blasts the ethics of corporate tycoons running firms built with “other people’s money”, and Berle and Means (1932) describe a fundamental misalignment of their incentives.

Corporate governance, broadly defined, continues this discussion. Capital is not *shmoo*, for who controls businesses matters, as do the institutions that determine this, the interest groups that affect these institutions, and thus the interface between financial economics and political economy.

While economic theory addresses all these issues, incentive misalignment attracts the most attention – perhaps because it highlights an internal contradiction within that theory. Neoclassical economics posits that individuals maximize utility and that firms maximize economic profits or, more precisely, the expected present values (NPVs) of their capital investments – which, in turn, precisely equal the expected present values of economic profits. This presents problems because, as Gabrowski and Mueller (1972) rightly note, firms are run by people. Which then is paramount: a CEO’s utility or her firm’s NPV?

Jensen and Meckling (1976), expanding earlier theories (Ross 1973) and reflecting previous empirical work rejecting pure value maximization (Baumol 1959; Grabowski & Mueller 1972 and others), provide the now standard resolution to this inconsistency. They assume utility maximization more fundamental, and their firms therefore do not maximize NPVs. The implicit sacrificed value they dub an *agency cost*. Specifically, they model outside investors – the firm’s owners or *principals*, as in Corporations Law – buying shares in firms run by utility maximizing insiders, whom Corporations Law declares to be their *agents*. Elaborating what is now standard terminology, they christen this divergence of interests a *principal-agent problem*, now often abbreviated to *agency problem*. Corporate governance is the study of agency problems and the monitoring and control mechanisms that limit agency costs.

Neoclassical economics posits that price competition culls firms that do not maximize NPVs, and thus holds that agency problems ought to be brief and economically negligible (Demsetz & Villalonga 2001). However, the empirical literature increasingly confirms non-value-maximizing decisions to be commonplace in corporate boardrooms, and far too economically important to be abstracted away (e.g. Shleifer & Vishny 1997; Gompers *et al.* 2003; Bebchuk & Fried 2004; Bebchuk *et al.* 2009).

If firms do not maximize value, managerial utility maximization might cause firms to effectively maximize something else. Baumol (1959) posits sales maximization; and Baumol (1967) argues that growth maximization best fits the facts – at least in the United States. Recent work in behavioral finance suggests alternative objective functions for individuals (Shleifer 2000), and Mueller (1992) argues that such considerations be incorporated into models of managerial behavior. Early work along these lines includes Stein (1989) and Scharfstein and Stein (1990), and Baker *et al.* (2004) review the area. Morck (2008) argues that a “loyalty reflex” demonstrated in Milgram’s (1974) experiments might compromise directors’ judgment, and draws from variants of those experiments and the broader social psychology literature to evaluate governance reforms. Nonetheless, most work in the area presumes utility maximization by managers. This is perhaps justifiable, in that the critical issue is that neoclassical economics assigns people, including managers, and firms different objective functions.

Thus, Grabowski and Mueller (1972), Jensen (1986), and others argue that top executives attain higher utility from running larger firms, and thus invest in negative PV projects merely to grow their firms. Jensen calls this sort of capital misallocation a *free cash flow agency problem*, defining *free cash flow* as the firm's cash flow (revenues minus operating costs) less the setup costs of all its positive NPV investments. A value maximizing firm should pay its free cash flow out to its shareholders, rather than invest it in negative NPV projects, but Jensen presents evidence that free cash flow agency problems are a first order determinant of overall agency costs. If this thesis is right, and the data suggest it is, microeconomic theory missed something very fundamental before the advent of agency theory.

Fortunately, this gap can be spanned with deeper economics (Jensen and Meckling 1976). Moral outrage about corporate misgovernance, in contrast, may be largely misdirected. Agency costs are often described as shareholder *wealth expropriation*. This is incorrect in an efficient market, where shareholders buy low because they rationally foresee extensive agency problems, costly monitoring and control mechanisms to limit agency problems, or a mixture of the two. Firms' founders thus absorb all agency costs by selling their shares at depressed initial public offering (IPO) prices; and the shares trade at fair value thereafter. Only outside shareholders who underestimate agency problems overpay and lose money on average, and this is expropriation unless *caveat emptor* applies.

The real social costs of agency problems lie deeper in inner workings of the economy. Inefficient resource allocation by firms costs money, as do the monitoring and control mechanisms that might limit those problems. Some level of agency costs is thus unavoidable. But both firms and economies can seek ways to reduce unavoidable agency costs.

All else equal, if corporate insiders more credibly pre-commit to maximize NPVs, investors pay more for shares. Higher share prices make outside capital readily available to firms that need it, permitting growth in firms with genuine business opportunities (Mueller 2006a). But less trusting outside investors and low share prices make outside capital scarce, growth is restricted to firms with abundant earnings from existing operations (La Porta & et al. 1997) – and these need not be the firms with the most farsighted, rational, or innovative leadership. Governments can curtail agency costs with institutions that better facilitate or require such commitments by corporate insiders. All else equal, success at this cuts costs of capital to entrants and incumbents alike; promoting competition, innovation, and efficient resource allocation. Corporate governance is therefore most fundamentally about how honest and able corporate insiders can most efficiently and credibly commit to limit agency costs, and about how governments can lower their costs of doing so (Shleifer and Vishny 1997; Bebchuk and Weisbach 2010).

Finally, a Handbook of Capitalism survey of corporate governance must pay due honor to Marx. The internal contradiction at the heart of corporate governance is not unrelated to Marx's more famous contention that competition drives *surplus value* to zero, and that this dooms capitalism. Schumpeter (1942, p. 31) interprets surplus value as the present value of abnormal returns to capital, essentially the NPVs of finance textbooks; and argues correctly that competition indeed drives these to zero. This still disturbs the equanimity of an occasional MBA student, who learns in microeconomics how economic profits fall to zero under perfect competition, and then learns in Corporate Finance of the need for "positive NPV" projects – that is, investments with positive economic profits. A well-placed between-term or summer break obscures this discrepancy from all but the most insightful students; but its true resolution, due to Schumpeter (1912), is that investment in innovation can have positive economic profits for a time (Cable & Mueller 2008); and that successful innovators are exceptionally foresighted and coldly rational rarities. Corporate governance is thus most fundamentally about how to entrust the governance of businesses to people who are both able and willing to find the positive NPV projects that Schumpeter evokes to save capitalism from Marxist doom. Good corporate governance is therefore fundamentally about piloting firms through disequilibrium situations, where economic profits can be very large, and positive or negative.

Ultimately, a free market economy creates social welfare by organizing the efficient division of labor (Smith 1776). Increased efficiency in corporate governance thus places corporations more reliably under the control of top executives with specialized skills, talents, or information necessary for leading their firm, organizing its core activities, developing its future capabilities, and mobilizing capital to financing its growth opportunism. But designing institutions that better align CEOs' personal utility maximization with value maximization also promises improved microeconomic efficiency. The normative goal of economic analysis in this context is trustworthy and well-qualified top corporate managers running firms that raise capital from rationally trusting investors. The positive goal of economic analysis in this area is enlightenment as to how top corporate insiders, firms, and investors actually behave, and the economic consequences of this.

## **2. AGENCY PROBLEMS AND THE WEALTH OF NATIONS**

The social purpose of the financial system is to entrust people's savings to firms governed by trustworthy people. Schumpeter's famous circular flow fails if savers do not trust financial institutions or financial markets, and instead bury coins in their gardens. But if savers can invest in bank accounts, bonds, and stocks knowing their money will be entrusted to genuine entrepreneurs who can capture

genuine economic profits, the economy can mobilize its capital to finance huge firm capturing vast economies of scale, daring technological innovators, and perceptive entrepreneurs who perceive previously unexploited profit opportunities (Mueller 2006a).

## **2.1 BIG BUSINESS, TRUST, AND RICHES**

Rosenberg and Birdzel (1986) argue that the joint stock company and other similar business organizational forms that let anonymous investors assemble huge pools of capital, and the institutional arrangements necessary to them, are fundamental to “how the West grew rich” and surpassed previously more advanced civilizations such as the Arab World, China, and India. The West developed institutions that let entrepreneurs assemble vast pools of capital from diverse investors, while the rest did not.

For large publicly traded companies to be viable, savers must trust corporate insiders to govern efficiently. Insiders can make commitments to do so at the firm level by granting shareholders voting rights, nominating trustworthy directors, mandating independent board committees, voluntarily disclosing important information, adopting managerial incentive pay schemes, and the like. However, Rosenberg and Birdzel stress how country-level institutional developments are more important to the credibility of such commitments. Promises to honor shareholders appear incredible without predictable laws and regulations governing financial markets, efficient and dispassionate courts, honest civil servants, mandatory disclosure rules, responsible government, and the like.

With the discovery of sea routes to around Africa to Asia and of the New World, the spice, fur, tobacco, and slave trades promised high returns but required vast capital outlays beyond the capabilities of even the wealthiest merchants and aristocrats. The solution to this quandary, the joint stock company, was 17<sup>th</sup> century Dutch invention.<sup>1</sup>

Before the invention of the joint stock company, maritime trade was organized one ship at a time. At the end of each voyage, the ship and cargo were sold and the proceeds divided between the captain and crew, the provisioners, and the financiers with each party's *dividend* (in the arithmetic sense) pre-specified in the contract. Financiers diversified the risk of loss at sea by buying shares in multiple voyages, rather than backing a single ship. Over time, these arrangements expanded to include several ships or all voyages for a fixed number of years.

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<sup>1</sup> Subsequent paragraphs draw from Frentrop (2002).

The modern world's first joint stock company, the *Dutch East India Company* or *Vereenigde Oost-Indische Compagnie* (VOC) was formed in 1602.<sup>2</sup> It was, according to the prominent investor Isaac le Maire (1558-1624), governed in a way “entirely absurd and impertinent” to the “displeasure and complaint of both the people in the street and the investors”.<sup>3</sup> This displeasure arose because, to le Maire's fury, the VOC directors refused to dissolve the venture, and instead used each voyage's profits to finance the next, paying dividends from the residual only. Moreover, they appeared intent on continuing this “absurd” practice indefinitely! Le Maire wanted his money out of the VOC because he felt its directors were running the company too laxly. They were building fine houses along Amsterdam's best canals, but letting others grab promising business opportunities in Asia.

On January 24 1609, in what (to our knowledge) is the first recorded corporate governance dispute, le Maire formally charged that the directors sought to “retain another's money for longer or use it ways other than the latter wishes” and petitioned for the liquidation of the VOC in accordance with standard business practice. The petition was denied, and investors who wanted out were forced to find another exit strategy. The only option left to them was selling the shares of the VOC they owned to other investors, for some merchants who had not participated in the initial voyage were indeed interested in earning dividends from a second round of voyages.

Because le Maire lost, a new business model arose – the publicly traded, indefinitely long-lived, joint stock corporation with publicly traded shares. This innovation financed the successive waves of industrial revolution that created the modern world. But le Maire was also quite likely correct in arguing that the directors of the VOC were growing fat and indolent, living off the shareholders' hard-earned money. Today's top managers have moved on, graduating from fine canal houses to Lear Jets, and shareholders object just as vociferously. And today's top corporate managers, just as confidently, assure shareholders it's all actually in their best interests.

Ultimately, Dutch shareholders accepted the new model, and British organizers copied it, especially after the Glorious Revolution of 1688 brought Dutch courtiers and ideas to London. Vast pools of capital soon funded huge joint stock companies, like the British East India Company and the Hudson's Bay Company which, at their apogees, owned sizable fractions of India and Canada, respectively. Others organized settler colonies, slaving expeditions, and slave plantations. The model soon spread to France and across Europe.

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<sup>2</sup> Lit. *United East Indian Company*. The VOC had antecedents in Flanders, and probably elsewhere; and businesses similar to joint stock companies likely existed in Roman times (Malmendier 2005).

<sup>3</sup> (Frentrop 2002, c. 2) superbly documents the early corporate governance disputes of the VOC, and is our source for the following historical case studies.

Questionable business models, especially slaving and slave plantations, and later the opium trade in China, attracted opprobrium to joint stock companies. But so did a popular perception of rampant mismanagement. Writing more than half a century after Smith (1776, bk. 5, c1, pt. 3, art. 1) despairs that “The directors of such companies ... being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.”

Courts, legislatures, and regulators ever since have sought to achieve the vast pools of capital joint stock companies permit without the “negligence and profusion” Smith denounces. As noted above, Rosenberg and Birdzell (1986) argue that western countries first developed institutions, legal and informal, that brought this goal closer than ever before, and that this is “how the West grew rich” and escaped the Malthusian trap that once bound every part of the world equally.

Subsequent research in corporate governance elaborates on this theme. Over the four centuries since the VOC first defied its shareholders, much has changed to better protect public shareholders in joint stock companies and similar structures – listed trusts, listed limited partnerships, widely held cooperatives, and the like – from errant or inept insiders. In some countries, more efficient hierarchies that better let honest and competent insiders credibly commit to good governance encouraged broader, deeper, and more efficient capital markets in a virtuous circle or expanding prosperity; while in other countries, this feedback loop either fails to form or quickly collapses after occasionally materializing (La Porta *et al.* 1997; Rajan & Zingales 2003), preserving de facto feudal institutions (Haber 2000; Acemoglu *et al.* 2001a, b)

Differences in national institutions therefore merit the interest of corporate governance researchers – either as factors directly responsible for these differences or as instruments behind other factors that are responsible. However, before exploring these issues, we pause to consider how governance quality can be measured and modelled.

## **2.2 WHO GOVERNS FIRMS MATTERS**

The literature on agency problems uses a range of models and notation that remains inconsistent. However, common themes are evident. Corporate insiders create wealth worth  $V$  from capital  $K$ , and the wealth created,  $\Delta V = V - K$ , is the NPV of the profits of their ventures. Agency problems arise



because the insiders must provide the investors – the people who provided the capital – with a return  $r$  that is higher the greater the risk the investors perceive in the venture. Business ventures have intrinsic risk, but agency problems add to this risk if insiders might keep part of  $r$ , or run the firm to enhance their utility and leave insufficient funds to pay the return the investors expect. Perceiving these elevated risks, rational investors withhold capital unless the promised return is very high or measures are in place to make the actual payment of the return credible. Agency problems thus increase firms' costs of outside capital, and sufficiently serious agency problems preclude access to outside capital altogether (La Porta et al. 1997).

The scope for agency problems depends on the benefits  $b$  corporate insiders pay themselves. Entrepreneurs contributing foresight, rationality, creativity, or other scarce talents the firm needs merit compensation  $b_E$ . Since this compensates them for their skill in creating value, it is theoretically paid entirely out of  $\Delta V$  and leaves sufficient earnings to pay investors  $r$ . However, utility maximizing insiders determine their own compensation, within the limits the country's regulations and the firm's contractual obligations permit.

The benefits insiders glean thus contain other terms. These private benefits of control come in two flavors. Some private benefits – social status and the sheer utility of power, for example – need not compromise the firm's ability to allocate resources optimally, though they can if their consumption induces unqualified insiders to retain control. Other private benefits – self-dealing, excess compensation, pet projects, pursuit of the good life at corporate expense, and the like – can allocate resources suboptimally - from the perspectives of as well as society. The former we call intangible private benefits of control, denoted  $b_I$ , and the latter we call tangible private benefits of control  $b_T$ .

Agency problems arise because, in general,  $b_E$  and  $b_T$  are indistinguishable until after the fact, and  $b_I$  may be largely unobservable. Monitoring and control mechanisms, whose cost we denote  $m$ , can curtail  $b_T$ , but generally curtail  $b_E$  and  $b_I$  too. Thus, outside investors' return is reduced by insiders' tangible private benefits  $b_T$ ; and may be further reduced if incumbent insiders' enjoyment of intangible private benefits  $b_I$  induces them to hold onto corporate power when more qualified people might take charge. The economic importance of such entrenchment is evident in the positive stock price reaction that occur upon announcements of the sudden deaths of many top corporate insiders (Johnson et al 1985; Erbani et al 1987; Faccio and Parsley 2009).

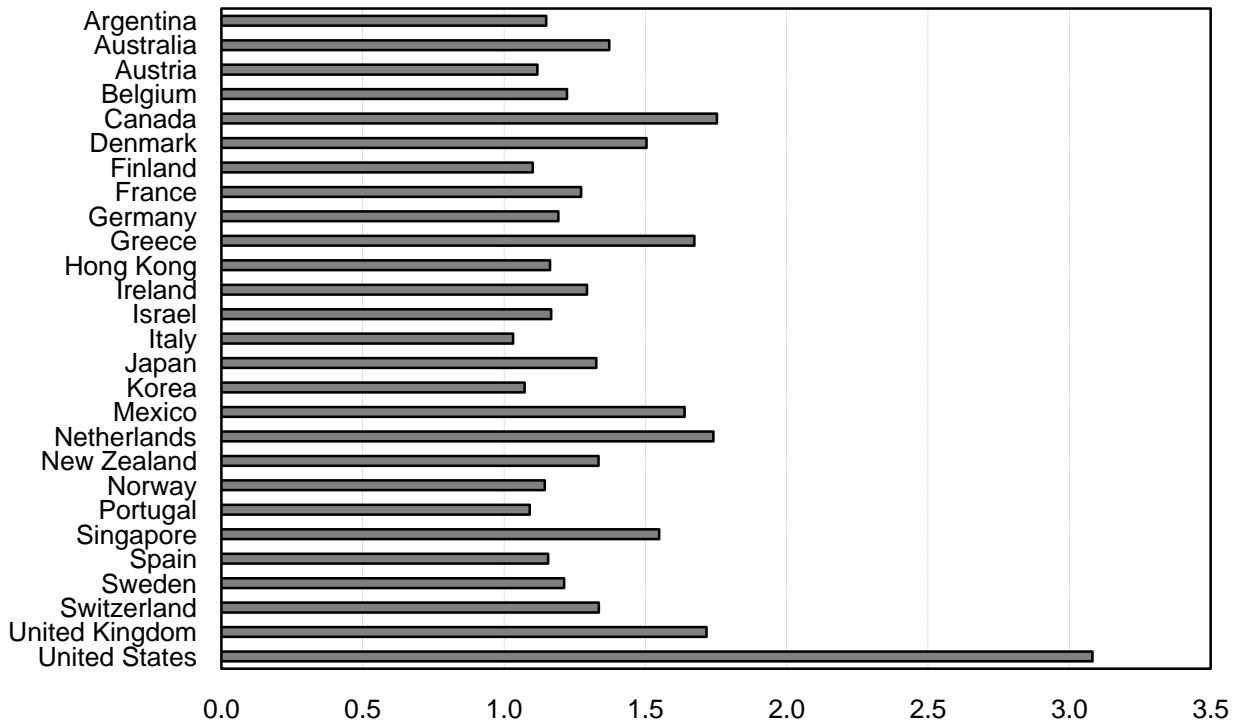
The efficacy with which insiders have added to a firm's value can be assessed by estimating Tobin's average  $q$  ratio,  $q = V/K$  (Tobin & Brainard 1976). If corporate insiders have, on average, added to a firm's value,  $q > 1$ . If they have, on average, destroyed value,  $q < 1$ . Since events beyond insiders'

control can also create or destroy value,  $q$  is usually adjusted with industry benchmarks and for other factors like firm size or age. However, we can proceed without loss of generality by declaring that  $q = 1 + NPV/K$ , where  $K$  is the firm's total stock of capital and  $NPV$  is the total aggregated net present value of all the firm's operations.

Figure 1 shows mean firm-level estimates of  $q$ , by country, from the mid 1990s from La Porta et al. (2002), who go on to show higher average  $q$  ratios in countries whose governments offer outside investors stronger legal rights against corporate insiders. Buttressing this finding, Gompers et al. (Gompers *et al.* 2003) show that US firms with stronger commitments to shareholder democracy in their corporate charters exhibit higher average  $q$  ratios; and Bebchuk and Cohen (2005a), Faleye (2007), and others show markedly depressed average  $q$  ratios in firms with staggered boards, that is, whose corporate charters grant directors three-year terms with a third facing reelection each year.

**Figure 1 Mean Tobin's Average Q Ratios around the World**

The means of the Tobin's average  $q$  ratios of the twenty largest listed firms in each country are proposed as gauges of the overall quality of corporate governance in each country. Values above 100% indicate a preponderance of value creating investments by the country's corporations in the eyes of their public investors. Data are for the mid 1990s, and the estimates are constructed by La Porta et al. (2002).



The limitations on shareholders' legal and democratic rights also clearly cause depressed average  $q$  ratios, rather than the converse. When US states pass legislation constricting shareholders' legal rights, the average share price of all firms incorporated in those states drops significantly (Ryngaert & Netter 1990; Jahera & Pugh 1991), as do the prices of firms that modify their corporate charters to limit shareholder democracy (DeAngelo & Rice 1983; Jarrell & Poulsen 1987, 1988; Bhagat & Jefferis 1991; Datta & Iskandar-Datta 1996; Bebchuk *et al.* 2002); though see also Comment & Schwert (1995), who highlight how less democracy can create more value under the right management, and McWilliams & Sen (1997) and others, who highlight tradeoffs between different dimensions of shareholder democracy.

An alternative approach Tobin's marginal  $q$  (Tobin 1969), designated here  $q'$ , assesses the efficiency of corporate investment on the margin. This must be distinguished from Tobin's average  $q$  (Tobin & Brainard 1976), discussed above. Tobin's marginal  $q' = dV/dK$ , the marginal value the firm's management creates from a marginal unit of capital.<sup>4</sup> The (tax adjusted) optimal value of  $q'$  is one, for if  $q' > 1$  the firm ought to expand and if  $q' < 1$  it has over-expanded. Higher average  $q = V/K$ , in contrast, always signifies net value creation. Empirical work reveals directly estimated marginal  $q$  ratios to be closer to one (or its tax-adjusted optimum) in firms about which investors have more information (Durnev *et al.* 2004) and in countries with Common Law legal systems that accord public shareholders stronger rights against insiders (Mueller, 2005, Gugler *et al.* 2004a; Gugler *et al.* 2007). Empirical studies using alternative measures of investment efficiency find similar cross country results (Rajan & Zingales 1998; Wurgler 2000).

Yet another approach compares the price of a firm's stock price after it announces a large investment relative to the price before to back out investors' estimate of the marginal  $q$  ratio of that investment (Morck *et al.* 1990). Increases in firms' research and development (R&D) spending sharply elevate share prices (Chan *et al.* 1990; Chan *et al.* 2001), as do foreign acquisitions by R&D intensive U.S. firms (Morck & Yeung 1992), consistent with innovation as a source of genuine economic profits

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<sup>4</sup> Marginal  $q$  ratios are also called profitability indexes in capital budgeting textbooks, and average  $q$  ratios can be conceived of as profitability indexes for entire firms, rather than marginal projects. Much confusion arises in the literature because of the confounding of Tobin's marginal and average  $q$  ratios (Durnev *et al.* 2004; Gugler *et al.* 2004b, a), for Hayashi (1982) shows extremely strong linearity assumptions are needed for  $q'$  to equal  $q$  and Durnev *et al.* (2004) find them empirically uncorrelated in US data. The validity of both measures depends on the efficiency of financial markets – that is, on investors accurately assessing the value implications of all the firm's investment opportunities and its top managers' decisions. If irrational investors bias asset prices,  $V$  must be reinterpreted as an unobservable fundamental value that would prevail under full rationality and full information. Also, a marginal  $q$  of one indicates only efficiency of capital allocation on the margin; and does not indicate the complete exploitation of all value maximizing inframarginal investment opportunities.

(Schumpeter 1912; Grabowski & Mueller 1978). In contrast, corporate takeovers, among the largest capital investments firms undertake, more markedly depress the share prices of acquiring firms with more evident agency problems (Morck *et al.* 1990) or in countries whose legal systems offer public shareholders weaker legal recourse against insiders (Mueller & Yurtoglu 2007). The change in value of the target and bidder combined suggest net value creation in many cases, but the mere fact that numerous value-destroying takeovers happen suggests that corporate insiders gain personal utility from ruling over larger business empires, regardless of their profitability (Morck *et al.* 1990; Mueller & Sirower 2003).

Determining the optimal protection of shareholders' rights is complicated by several interrelated considerations. First, shareholders entrust corporate governance to top insiders because those insiders possess exceptional foresight, rationality, or creativity. This means shareholders recognize that insiders are better qualified to govern the firm, and that excessive shareholder power might interfere with this. Indeed, limits on shareholder democracy correlate with both unusually good and unusually poor corporate performance (Adams *et al.* 2005; Adams & Ferreira 2007), suggesting that democracy limits both extremes.

Governments can impose conditions on corporate charters, force firms to spend money making themselves transparent, and assign shareholders stronger rights in court. All such measures can limit corporate insiders' freedom to extract private benefits of control, but always at a cost. Just as more democratic charters can limit truly creative CEOs' freedom of action, transparency requirements entail auditing and compliance costs and legal rights enable opportunistic and even extortionary lawsuits (Jensen & Meckling 1976).

### **2.3 SHAREHOLDER VALUE AS AN IMPERFECT GOVERNANCE METER**

The agency literature tends to identify superior corporate governance with higher share prices. Normative chapters in economics and finance textbooks charge firms with maximizing net present values, the expected discounted values of future profits. This makes sense, for outside investors almost always invest solely to grow their savings. Obviously, a sole proprietorship maximizing its owner's utility and financed solely with her savings entails no agency conflict, for owner and manager are one; though the textbooks describe this situation poorly. But capitalism prospers off specialized firms exploiting economies of scale, and this typically requires mobilizing very large pools of outside investors' capital. This justifies shareholder value as a corporate governance metric; however, conditions under which the metric can go askew merit note.

First, shareholders are not the only people with investments in a firm. However, the prices of firms' other securities – bonds, debentures, bank loans, etc. – fluctuate relatively little compared to stock prices. A firm's obligations to its other investors almost always have legal priority over those to its shareholders. Firms with cash flow shortfalls must cut or skip dividends first. Only if the shortfall is very large does a firm lay off employees or miss an interest payment, for the former triggers often costly labor laws and the latter triggers bankruptcy. Thus, any cash flow shortfalls initially hurt dividends, and hence shareholder wealth, before affecting any other securities. Likewise, any unexpected positive revisions in a firm's future cash flow estimates normally augment expected future payouts available to common shareholders, and thus raise the share price. Bondholders do not get higher interest payments whenever the firm has an unusually good year. Consequently, most of the variation in a firm's market value, and therefore in its average q ratio, is due to variation in shareholder value.

This is the fundamental reason why corporate governance must focus on shareholder value. Shareholders are not more important than the firm's other claimants; but their squawking amid plummeting share prices turns out to be a highly sensitive corporate misgovernance alarm system. If shareholders anger can prevent or reverse misbegotten corporate policies, creditors and workers are protected.<sup>5</sup> Nonetheless, many countries charge top insiders with balancing shareholders' interests against those of all stakeholders – creditors, employees, retired employees, consumers, suppliers, the environment, the state, the community, and so on – seemingly to the detriment of overall wealth creation (Klaus Gugler & Yurtoglu 2003) and quite probably to overall employment levels as well (Jensen & Meckling 1979; Faleye *et al.* 2006).

Second, stock prices can misrepresent the quality of corporate management. If the firm is perfectly transparent, public investors can estimate the cash flows each of its projects will generate in all future periods. But the public relies on public information, so shareholders might think brilliant entrepreneurs mad and depose them, or laud truly mad corporate insiders as brilliant. The former misperception retards growth, and the latter destroys existing wealth.

This seemingly obvious point nonetheless causes much confusion. The Dutch court that upheld the VOC's right to life encapsulated this confusion in a mantra for disgruntled shareholders: "if you

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<sup>5</sup> Of course, this early warning system can fail, and a corporate decision can be so awful as to adversely affect creditors, workers, or other stakeholders before shareholders can sound an alarm. The laws of most countries recognize that, in such cases, top insiders' duty is expanded to encompass all affected stakeholders. Moreover, if shareholder value is already near zero, shareholders may favor high risk gambles that might save the firm but are likely to leave creditors or other stakeholders worse off in a looming bankruptcy. In such cases, the legal systems of most countries shift insiders' duties towards creditors – now the likely residual claimant.

don't like the way the firm is run, sell your shares." If the firm was badly run when the shareholders bought their shares, and is no worse run now, this is reasonable advice. But selling out is no solution to unexpected misgovernance. In an efficient market, the shares of an unexpectedly mismanaged firm drop instantly, and fetch too little too late to assuage disgruntled shareholders.

However, outside investors sometimes do misgauge the true value of a firm's ongoing investments. Firms are not perfectly transparent; their inner workings can be occluded by unavoidable information gathering and processing costs, or by deliberate obfuscations designed to conceal dubious management decisions. Taxes and other transactions costs further complicate the picture. The validity of the efficient markets hypothesis – the speed and accuracy with which all relevant new information accurately revises stock prices to reflect fundamental values – is therefore critical to the validity of shareholder value being a defensible metric of corporate governance. Tobin (1984) thus stresses the functional form of the efficient markets hypothesis as holding if financial markets are "efficient enough" to guide capital to its highest-value uses with a tolerably low error rate. The extent to which financial market inefficiency biases corporate governance is one of the most understudied topics in current finance research (though see Wurgler 2000; Durnev et al. 2004).

Third, bubbles and financial panics are especially troublesome deviations from market efficiency, and recent work in behavioral finance suggests that investors' perceptions can be distorted in more normal market conditions as well. All the stocks in an industry, or even in a country, can rise or fall because of altered terms of trade, consumer tastes, or government policies. Thus, the high Tobin's average  $q$  ratios of US firms in Figure 1 might reflect more sensible regulations, a low dollar, or an expanding stock market bubble in the mid 1990s. Some evidence suggests that firms' share prices relative to each other retain a relationship to their relative underlying fundamentals even as prices overall rise and fall with bubbles and panics (Samuelson 1998; Jung & Shiller 2005). These possible problems motivate measuring the quality of governance by firms' average  $q$  ratios relative to industry or country benchmarks (Morck et al. 1988).

Fourth, companies can go from seemingly robust financial health to probable bankruptcy quickly, depressing both their equity and debt valuations, and even putting employment and factor market contracts at risk. Once bankruptcy is in the cards, the values of debt and other contractual obligations fluctuate too, changes in shareholder valuation are no longer the whole picture. If only debt is affected, switching the focus from shareholder value to the firm's total market value is viable. If supplier and employment contracts are put at risk, these valuation decreases must be weighed in too.

Fifth, political rent seeking can disconnect firms' NPVs, and therefore shareholder value, from genuine economic profits. In many countries, one of the highest NPV investment firm can undertake is bribing public officials – either directly or, more commonly, indirectly via favors (Baumol 1990; Murphy et al. 1991) – to gain state-protected market power, subsidies, tax breaks, or regulatory favors. The importance of such favors become visible when corrupt governments change, as when the stocks of Indonesian firms favored by President Suharto collapsed upon his overthrow (Fisman & Miguel 2008). Is a firm whose share price soars because of the hugely profitable bribing of a politician a “well-governed” firm? Is a firm ill-governed if it refuses to bribe officials, and therefore suffers regulatory disfavor that depresses its profits and share value? The answer to both is affirmative if shareholder value is the metric used. But, this is misleading because corporate governance is fundamentally about allocating the economy's savings efficiently. Corruption can twist shareholder value badly out of alignment with efficient capital allocation.

Despite all of these caveats, shareholder value is the best corporate governance gauge available. Shareholders, like canaries in a mine, are especially sensitive to danger. Their squawking is a sometimes overly sensitive alarm system, and they occasionally doze through an approaching crisis. We therefore keep our eye on share prices, but bear in mind the conditions under which this gauge can stick.

### **3. CONSTITUTIONAL FINANCE**

Good corporate governance is difficult because of an underlying time inconsistency problem: before corporate insiders sell shares to outsiders, they promise value maximization so the shares fetch the highest possible price. After the shares are issued, the same insiders rationally appreciate the utility of policies other than shareholder value maximization. Good corporate governance thus entails a credible commitment against insiders maximizing their utility ex post. The problem thus resembles that of a government that must tie its own hands (Kydland & Prescott 1977), and thus the problem of designing an optimal constitution (Buchanan & Tullock 1962; Mueller 1996). The best tether is often unclear because the non-value-maximizing actions corporate insiders might take are often hard to anticipate – even for the insiders themselves.

This is most evident in the different attitudes towards good governance measures held by insiders of younger versus older firms. Younger firms' insiders, contemplating issuing new shares to public investors, logically want each share to fetch as high a price as possible, and so favor strong monitoring and control mechanisms, which are indeed more commonplace in the charters of firms with more bountiful growth opportunities (Durnev and Kim, 2005). But a mature or declining firm's share

issuance days are in its distant past, and its insiders quite plausibly come to appreciate larger private benefits of control to a higher share price (Grabowski & Mueller 1975). Thus, a time inconsistency problem inevitably arises as a firm ages, despite the most earnest protestations of the young firm's insiders.

How countries deal with this time inconsistency matters, for this affects the pace of Schumpeter's creative destruction and thus the country's long-term economic growth (Shleifer & Wolfenzon 2002; Rajan & Zingales 2004; Morck *et al.* 2005; Mueller 2006a). This is readily illustrated by the venture capital cycle documented by Gompers and Lerner (Gompers & Lerner 1999), whereby innovative entrepreneurs build new firms, entrust them to professional managers, sell out, and use the proceeds to start another innovative venture. This cycle, or something analogous to it, appears important in the United States and other high-income economies, but is altogether lacking in low-income economies (Morck *et al.* 2005). If professional managers cannot be trusted, the entrepreneur must stay in charge. She cannot cash out, nor can her children, nor her children's' children. Rather, they must take their pay in the form of private benefits. Such an economy is bereft of entrepreneurship and its capital assets are governed by heirs, who are rarely the beneficiaries of talent as well as wealth. To avoid this fate, capitalist economies need institutions that render professional corporate managers credibly trustworthy by constraining their scope for private benefits.

The corporate finance literature often follows Jensen and Meckling (1976) in referring to corporate insiders' generic non-value-maximizing behavior as "shirking" – relaxing to enjoy a philosopher's good life instead of striving to defeat Keynes' "dark forces" to unveil the future. This is historically valid, for in his complaint to the Dutch court, le Maire accused the VOC directors of neglecting the company to enjoy quiet lives of luxury in expensive Amsterdam canal houses. It is also empirically supported, for John et al. (2008) present evidence of personally risk-averse US CEOs safeguarding their perks and pay by shunning risky projects that nonetheless likely had positive NPVs.

Yet other utility maximizing CEOs might spend their investors' money to build ego-satisfying, but ultimately financially unstable, corporate empires (Jensen 1986), to pay themselves handsomely for running the firm poorly (Jensen & Murphy 1990), or on "perks" like executive jets (Yermack 2006). Utility maximizing CEOs might restrict hiring to a favored gender or an ethnicity, or to ego-pleasing "yes-men", even though this fills the firm with suboptimally qualified employees (Becker 1957). Politically or socially aware CEOs might even spend their investors' money lobbying for favored political agendas (Högfeldt 2005) or funding pet charities (Atkinson & Galaskiewicz 1988) – all with the best of utility maximizing intentions.



The list of tangible and intangible *private benefits of control* insiders might extract, and the cost to share prices of these actions, is impossible to complete for it grows naturally with financial innovations like stock options, technological innovations like commuter helicopters, new tax loopholes, and so on. Credibly pre-committing to avoid each and every conceivable item on this list is beyond the ability of even the finest contract lawyers. Credible commitments to good governance must thus be of a more general character: they must be open-ended promises to inform and empower shareholders

Genuinely credible commitments may therefore require that public policy enforce governance standards. Empirical evidence suggests that public policy is typically more effective than measures taken by individual firms in reducing agency costs (Doidge *et al.* 2007). But arguments that regulations, such as the Sarbanes Oxley Act in the United States, impose inefficiently large compliance costs on listed firms cannot be dismissed summarily (Romano 2005).

Obviously, the more credible the good governance measures with which the entrepreneur can bind the professional CEO who succeeds her, the higher the return to entrepreneurship. Public policies that enforce higher standards of corporate governance are thus defensible to encourage entrepreneurship. Since new firms often bring important productivity-enhancing technologies into play, this has dynamic efficiency consequences (Schumpeter 1912). Even absent new technology, higher returns to the founders of new firms encourage entry and enhance competition.

This concern for long term dynamic efficiency, rather than ethical arguments about expropriation, is the more defensible economic logic underlying corporate governance laws, regulations, and standards. These let corporate insiders tie themselves and their successors to the mast, so that public shareholders can rationally expect agency problems to be mitigated, and thus can be persuaded to pay more for corporate shares. Since Schumpeter (1912) argues that much economic growth arises through innovative entrepreneurs founding new firms, unnecessarily large agency costs could reduce social welfare quite substantially over the long run.

Different countries use different mixes of alternative mechanisms to encourage shareholder value maximization and discourage insiders from shirking or otherwise extracting private benefits. And given these, different firms can constrain their insiders in different ways by relying on some available mechanisms more than others. These mechanisms range along a spectrum from open access governance, where shareholder democracy (with all its flaws) is paramount, to restricted access governance, where big business is entrusted to (hopefully enlightened) corporate despots.

### **3.1 SHAREHOLDER DEMOCRACY**

The most basic such mechanism is shareholder democracy, as specified in law and by the firm's *charter*. A corporate charter is essentially a firm's constitution, specifying voting rights, constituencies, voting procedures, allocation rules for board seats, and the like. This reflects historical accident: Joint stock companies arose before governments were ready for them and, in England and elsewhere formed under laws cribbed from those pertaining to municipal governments (Dunlavy 2007).

This made a certain sense, in that both towns and joint stock companies are the joint property of large numbers of strangers, whether landowners or shareholders. Thus, both are legal persons capable of owning corporate property and run by elected boards and chief executive officers within the constraints of bylaws and corporate charters that specify rules for electing boards and enacting bylaws. Some early corporate charters even imitated municipal elections in granting one vote per shareholder, rather than the modern standard of one vote per share (Dunlavy 2007).

Corporate charters and bylaws, like those of towns and cities, specifying voting rights, election rules, administrative organization, financial accountability, audit procedures, and the general freedom of action entrusted to the board and management. Some corporations can thus be substantially more democratic than others. Gompers et al. (2003) rank the strength of shareholder democracy in each of a large sample of US firms in the 1990s, and find that more democratic governance correlates significantly with higher shareholder valuations and superior financial performance.

Shareholders' ultimate trump card is the annual general shareholders meeting, at which all shareholders can vote out the board of directors if they don't like the way the company was run. A new board can then fire the old managers, hire new ones, and set the company on a new course more to the shareholders' liking. To stay in charge, the VOC's directors had to convince a majority of its shareholders that the strategy of staying in business perpetually made sense. They succeeded – in part because shareholders who disagreed sold out and others who agreed bought in.

How shareholder democracy works thus depends critically on the corporation's voting rules at that meeting (Bebchuk & Cohen 2005a). Corporations experimented with remarkably variegated shareholder voting rules through the 19<sup>th</sup> century (Dunlavy 2007). One especially democratic model was one-vote-per-shareholder, based on a direct analogy to municipal corporations (Maier 1993). Other early English trading companies, for example the Hudson's Bay Company's 1670 charter, pioneered one-vote-per-share instead, and the latter model won out by the 20<sup>th</sup> century.

The logic behind restricting large shareholders' relative power is that a firm's top managers can better act in all the shareholders' true interests if they are not controlled too heavily by any given shareholder – precisely the message in the VOC example cited above. But an *a priori* equally plausible

chain of reasoning holds powerful large shareholders improve the quality of corporate decision-making because they have the sophistication, resources, and financial incentives to monitor the firm and to intervene to correct wrong strategies (Shleifer & Vishny 1986). The latter logic might not justify super-voting shares for insiders, but it can justify one-vote-per-share under appropriate convexity assumptions (Grossman & Hart 1988).

Other companies in the 19<sup>th</sup> century had sliding scales, where shareholders with larger stakes had fewer votes per share – so as not to marginalize smaller shareholders utterly, while still giving larger shareholders more say (Dunlavy 2007).<sup>6</sup> Related structures survive to the present in many countries in the form of voting caps, which restrict any shareholder from voting more than a certain fraction of a company's shares. For example, voting caps currently limit the power of large shareholders in all the major Canadian banks.

But these relics are oddities. In 1811, New York State mandated one-vote-per-share (for manufacturing corporations), and other states followed suit. One-vote-per-share became the standard for shareholder democracy by the early 20<sup>th</sup> century. One-vote-per-shareholder is now barely a historical footnote, and further reforms to let insiders' shares have superior voting pushed some firms and countries to antidemocratic extremes, which we explore below.

Even under one-vote-per shareholder, consulting all the shareholders for every business decision was impracticable – even more so in earlier centuries when transportation by horse or clipper made quick meetings impossible. This forced dispersed shareholders to entrust important decisions to the board and top management.

Electing highly trustworthy directors was not always easy. For example, Charles II granted Rupert Palatyne, his cousin and a royalist Civil War hero, a monopoly on the fur trade out of most of what is now Canada. Palatyne organized an IPO in 1670, and the Hudson's Bay Company's shareholders elected a board of elite courtiers. From 1685 to 1690, the Bay's share price soared as it paid large and increasing dividends, and then the whole board resigned. The new directors discovered the meteoric dividends were financed with asset sales, and the share price plummeted accordingly – well after the old directors safely sold all their shares at the peak. The law courts had no sympathy for the impoverished

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<sup>6</sup> Alexander Hamilton supported such a graduated voting scale in his proposal for the Bank of the United States, arguing that "A vote for each share renders a combination of a few principal stockholders, to monopolize the power and benefits of the bank, too easy. An equal vote to each stockholder, however great or small his interest in the institution, allows not that degree of weight to large stockholders which it is reasonable they should have, and which, perhaps, their security and that of the bank require"

shareholders, for one of the old board's last decisions was to pay a "special dividend" in gold for the King.

Over the subsequent decades and centuries, directors' duties gelled around preventing such abuses. At Common Law, directors' fiduciary duty is to put aside their private interests, act for the shareholders, and treat all shareholders (even Kings) equally. In most Common Law countries, these duties are fundamental legal principles.

However, the Common Law courts may trust shareholder democracy excessively. First, most small shareholders do not vote in firms' shareholder meetings. This because a typical small shareholder, perhaps owning only a few hundred or a few thousand dollars worth of stock, must spend considerable time and money to become informed about the issues; and these costs typically exceed the dollar gain governance improvements would create for her (Grossman and Hart 1980). Second, most shareholder votes resemble elections to the North Korea People's Congress more than to the New York City Council. The typical election has one candidate standing for each board position, and shareholders are offered the choice of voting for the candidate or withholding their votes. The CEO traditionally selected the candidates, though existing directors are now sometimes entrusted with selecting candidates instead.

Contested elections do occur, but rarely. A *proxy challenge* – a campaign to replace incumbent directors with a so-called *dissident slate* of candidates – is time consuming and expensive (Dodd & Warner 1983; Brickley 1986; Pound 1988; DeAngelo & DeAngelo 1989; Bhagat & Jefferis 1991; Van Nuy 1993; Mulherin & Poulsen 1998; Romano 2003; Davis & Kim 2007). Dissidents must campaign with their own money, while insiders can use corporate funds; dissidents' access to shareholders' names and addresses can be constrained; and small shareholders may still not be motivated to investigate the issues and vote. Proxy contests are therefore rare, and occur only where the costs of mismanagement are perceived to be great (Bebchuk & Hart 2001). This means only extremely large-scale shareholder value devastation is likely to result in insiders being turfed out.

### **3.2 REPRESENTATIVE SHAREHOLDER DEMOCRACY**

These and other limitations on direct shareholder democracy lead recent rounds of expert reports in Australia, Britain, Canada, and other Common Law countries to advocate more responsible representative democracy: more independent directors, independent "lead directors" or board chairs, and key committees composed of independent directors. The Sarbanes Oxley reforms in the US also mandate greater numbers and responsibilities for outsider directors.

The social psychology literature (Milgram 1974) shows that people tend to reflexively obey legitimate authority figures unless dissenting peers or alternate authority figures voice dissent, so these reforms are defensible as ways of limiting excessive director loyalty to CEOs and promoting critical thought (Morck 2010). Of course, endless debate over every decision is unhelpful, and an optimal amount of dissent ought to exist (Landier *et al.* 2009).

Consistent with such a role for independent directors, Weisbach (1988) finds subpar performance more likely to trigger CEO turnover in US firms whose boards contain more independent directors. However, whether or not independent directors increase shareholder value is unclear. Although early work finds no correlation, more recent studies indicate a growing traction (Kaplan and Weisbach 2010). This may reflect increasingly rigorous definitions of independence preventing CEOs selecting directors by combing through lists of their friends for people who meet the literal criteria for independence.

Defining “independence” for directors can be tricky. People drawn from the ranks of top management are clearly not outsiders; defying the CEO puts their jobs at risk. People with financial ties to the firm – its lawyers, accountants, marketing agencies, or suppliers – are also unlikely to defy the CEO, for they risk losing business. CEOs often invite other CEOs to serve as independent directors, raising the possibility of tit-for-tat (Axelrod 1984) mutual support networks insulating each other from genuine shareholder democracy.

Especially tight such networks of interlocking directorships are found in France, where the alumni of a few elite colleges fill most top government and business jobs (Kramarz & Thesmar 2006), often migrating from civil service to top business positions over their careers (Bertrand *et al.* 2006). Pistor (2010) details similarly tight networks interweaving the top echelons of the Communist Party into the boards of Chinese financial firms. Reputational concerns might keep even imperfectly independent directors focussed on shareholder value and firm performance (Fama 1980; Fama & Jensen 1983), and Kaplan and Reishus (1990) find senior US executives whose firms cut their dividends only half as likely as their peers to be offered additional outside directorships. But loyalty to fellow network insiders might just as easily induce a defensive huddle (Hallock 1997; Haunschild & Beckman 1998).

The effectiveness of shareholder democracy depends critically on both corporations’ charters and bylaws, and on national standards. For example, American companies can adopt “poison pills”, rights offerings that massively dilute the stake of any unfriendly shareholder bent on acquiring enough stock to oust the board (Ryngaert 1988; Brickley *et al.* 1993; Brickley *et al.* 1994), or amend their corporate charters to establish staggered boards (Bebchuk & Cohen 2005b), which recast annual

shareholder votes as electing only one third of the board every year for a three year term. Bebchuk and Cohen find that these innovations, especially staggered boards, substantially depress shareholder value in US firms. In contrast, British and Canadian courts found these innovations to violate directors' traditional Common Law duties to treat all shareholders equally and to act for shareholders. Staggered boards are disallowed in both countries, and poison pills are banned in Britain and vulnerable to legal challenge after a brief stay in Canada.

### **3.3 MULTIPLE CONSTITUENCIES**

Shareholder democracy plays a role in corporate governance in every country, but some restrict it even more severely than others. A major recent trend is the shifting of directors' duties away from shareholders and towards more vaguely defined "stakeholders". These reforms are inspired by Germany and other central and northern European countries that long explicitly set directors a fiduciary duty not only to shareholders, but also to "stakeholders" – employees, customers, suppliers, the environment, the people, the State, etc. Different countries operationalize this differently.

A large listed German firm typically has a management board, or Vorstand, charged with week-to-week operational decisions, and a supervisory board, or Aufsichtsrat, charged with higher level strategic decisions. Half of the supervisory board members in large firms are elected by shareholders and the other half by employees, though the chair, an additional shareholder representative, can break ties. In addition, German companies have works councils (Betriebsrat), elected by employees and empowered to veto human resources decisions. Supervisory board members owe a general fiduciary duty to all stakeholders, though their constituencies presumably affect their priorities.

This system, established by Adolf Hitler to inspire boards with a duty to stakeholders – such as their Volk, Reich and Führer (Fohlin 2005) – still inspires progressive reformers today. Several US states, beginning with Massachusetts and Pennsylvania, now mandate a German-style fiduciary duty of directors towards all stakeholders, not just shareholders (Karpoff & Malatesta 1989). A recent Supreme Court decision (*Peoples v Wise*) in Canada also shifts directors' duty, but to act in the interests of "the corporation", rather than those of "the shareholders, creditors, employees, or any other stakeholders". This engenders considerable confusion, for the "interests" of a fictitious legal person are not readily discernable, and the court provides no further guidance. Recent reforms in Britain also move that country's directors' duty towards a broader responsibility to stakeholders, and a less exclusive duty to shareholders.

With stakeholder rights ascendant, shareholder democracy is necessarily weakened. CEOs and directors, citing their duties to other stakeholders, can instruct their firms' lawyers to fight shareholders seeking to oust them. Since almost any corporate policy can be defended as in the interests of some stakeholder, top insiders need only pick the stakeholders whose interests align with their own on an issue-by-issue basis to defend sequences of entirely self-interested decisions. Since Arrow (1964) shows that no simple rule aggregates the preferences of heterogeneous constituents, such cynically self-interested governance cannot be judged socially worse than alternative decision rules.

### **3.4 OPEN ACCESS CORPORATE GOVERNANCE**

In politics, the electorate's ultimate power is to "throw the bums out" (Haber *et al.* 2008). Shareholders have a similar last line of defence: the corporate takeover. If insiders let the share price fall too far below its replacement cost<sup>7</sup> per share, they put their firm "on sale". Even if the dismayed shareholders cannot replace top management, they can sell their shares to a raider who, upon acquiring undisputable control, can fire the board and bring in new management.

In the US in the 1980s, serial raiders amassed huge fortunes buying up misgoverned firms whose share prices were severely depressed (Easterbrook & Fischel 1982; Jensen & Ruback 1983; Jarrell *et al.* 1988; Morck *et al.* 1989). After gaining control, the raider replaced management, imposed credible commitments to good governance, and sometimes broke bloated firms up into more manageable pieces (Berger & Ofek 1996). This done, the raiders sold the firms back into the open stock market, where they fetched far more than acquiring the mismanaged firm cost. This "market for corporate control" saw raiders specializing in fixing broken firms, much like specialists in gentrification buying broken down houses, fixing them up, and selling them. Criticisms that raiders create no value because they build no new factories or office buildings miss this fundamental point.

A more considered criticism is that some raiders are worse managers than the ones they oust. Jensen (1986) argues that ego-driven CEOs sometimes use takeovers to build shaky corporate empires that they cannot manage, and a wealth of empirical evidence now supports this (Lang & Litzenberger 1989; Morck *et al.* 1990; Lang *et al.* 1991; Opler & Titman 1993; Christie & Nanda 1994). This is plausible, for much evidence suggests top corporate insiders gain more utility from running larger firms (Baumol 1959; Grabowski & Mueller 1972).

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<sup>7</sup> Chapter 16 in this volume, "Mergers and the Market for Corporate Control" by D Mueller, provides a more in depth discussion of the issues discussed in this sub-section.

Another plausible criticism is that stock market bubbles can trigger nonsensical takeovers (Shleifer & Vishny 2003; Rhodes-Kropf & Viswanathan 2004; Rhodes-Kropf *et al.* 2005). Acquirers, whose own shares are boosted by a bubble in, say high tech stocks, can use their overvalued shares as a currency with which to buy other firms, and can again amass huge corporate empires. Once the bubble bursts, former target shareholders left holding the acquirers' now greatly deflated stock may well feel short-changed (Moeller *et al.* 2005; Mueller & Yurtoglu 2007).

These problems call for better corporate governance of acquirer firms, not prohibitions of takeovers. Indeed, bad acquirers in the 1980s often became targets of more adept raiders (Mitchell & Lehn 1990). Mueller (2010) points out that while hostile takeovers can be an effective constraint on managerial excess, "the market for corporate control is not sufficiently effective to eliminate all wealth destroying mergers." In particular, many countries and U.S. states curtail their markets for corporate control in response to various mixtures of legitimate and illegitimate concerns.

Some countries resist this trend more than others. In Britain, the courts nullified a succession of devices CEOs tried to use to stop raiders, and a robust market for corporate control persists, preventing insiders from becoming too neglectful of shareholder value or they risk ouster by a raider (Cheffins 2009). Takeovers also continue to rein in any excessively utility maximizing top managers of firms that lack defensive armaments in the United States, Canada, Australia, and elsewhere.

However, hostile takeovers, where a raider aggressively buys control with the avowed purpose of ousting underperforming top management, grew rare in the U.S. after the 1980s because potential target firms' top managers erected arrays of takeover defences (Mikkelsen & Partch 1997). As mentioned in 3.3, the most important are poison pills, rights offerings that dilute raiders' stakes before they become large; staggered boards, which lock directors into three year terms with a third standing for election each year and thus make a raider wait two years before replacing a majority of directors; and state takeover laws, which empower CEOs to litigate against takeover bids (DeAngelo & Rice 1983; Linn & McConnell 1983; Jarrell & Poulsen 1987; Mitchell & Netter 1989; McWilliams 1990; Bhagat & Jefferis 1991; Comment & Schwert 1995; Borokhovich *et al.* 1997; Bebchuk *et al.* 2002; Cheng *et al.* 2005).

Takeovers still happen in the US, but now require the consent of the incumbent management, who have the power to waive poison pills, fire staggered boards, and undo other takeover defences. Underperforming managers now expect large golden parachutes, side payments for dismantling takeover defences and stepping aside (Hartzell *et al.* 2004). Since the potential gains from fixing up broken corporations can be very large, even very large golden parachutes can still leave the control



transaction viable. Only if the CEO gleans so much utility from remaining in control that no feasible golden parachute side payment can induce him to step aside does the market for corporate control fail. Since these negotiations are conducted behind the scenes, we have no reliable estimate of the full shadow cost of takeover defences to the US economy in terms of takeovers of underperforming corporations that did not happen.

Underperforming firms in other countries use different takeover defences. In Japan, the keiretsu defence was long favoured (Sheard 1991; Morck & Nakamura 2005). This entails a group of CEOs, who all fear ouster by raiders, greatly increasing their firms' treasury shares – shares that exist, but have not been sold to any investor. The firms swap these shares with each other so that each ends up with a majority of its shares held by other firms in the new keiretsu group. Each of thirty firms might end up with a 1% or 2% stake in every other firm in the group, and every firm in the group then ends up more than 50% owned by other firms in the group. At no cost, these firms are now all insulated from raiders, for the groups' CEOs pledge never to sell their shares in each others' firms. The keiretsu defence remains important in Japan, but shareholder pressure to sell interlocking shares has induced many firms to adopt poison pills in recent years.<sup>8</sup>

Dutch firms use a variety of oligarchic mechanisms that let insiders control seemingly widely held firms with no fear of shareholder rebellion (de Jong *et al.* 2001; de Jong & Roell 2005). As noted above, large seemingly widely held German firms are controlled by the country's big banks, which are empowered to vote small shareholders shares (Fohlin 2005).

But most countries in Continental Europe, Asia, and Latin America have no effective market for corporate control. This is because most listed companies have a controlling shareholder, usually a wealthy business family, who controls an effective majority of the votes in the shareholder meeting, and thus essentially appoints the board (La Porta *et al.* 1999; Fogel 2006). As long as the CEO and other top managers please that shareholder, their positions are secure. In these countries, corporate governance is the realm of despots (Gugler *et al.* 2007).

#### **4 CORPORATE DESPOTS**

Like the government of nations, corporate governance can provide very open access or restrict decision-making to tiny elites of insiders (North *et al.* 2009). Entrusting governance to a controlling shareholder brings to the corporation the efficiency of the dictator (Blau 1957). As in politics, a brilliant and highly

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<sup>8</sup> See e.g. Andrew Morse & Sebastian Moffett, 2008. Japan's Companies Gird for Attack - Fearing Takeovers, They Rebuild Walls - The Rise of Poison Pills. Wall Street Journal

ethical despot can provide very good government (Johnson 1910). But several strands of empirical work converge to show that, again as in politics, despots of this ilk are exceedingly rare.

#### **4.1 ENLIGHTENED CORPORATE DESPOTS**

If a firm's controlling large shareholder demands economic efficiency, top management has little choice but to forego maximizing their utility functions and maximize value (Shleifer and Vishny 1986). The individuals or institutions that can afford to hold large equity blocks in large corporations are typically either enormously wealthy families or institutional investors like pension funds, insurance companies, banks, government organs, and large charitable foundations. All of these employ sophisticated financial analysts, accountants, and lawyers who can and do take action to make sure the firms their employer controls are run as their employer wants. Because large shareholders have large multimillion dollar investments in their firms, the benefits of better management quite often outweigh their costs of becoming informed and taking action. Large shareholders thus overcome the free rider problem of Grossman and Hart (1980).

Institutional investors' effect on corporate governance appears to vary markedly across countries. British pension funds and insurance companies were empowered by postwar Labour governments to finance workers' retirements, and are largely run by independent professional fund managers. Black and Coffee (1994) describe how the institutional investor whose portfolio is most heavily weighted in a problem firm is expected to take the lead in forcing changes, and how other institutional investors organize to back the lead institution. Cheffins (2009) also highlights the effectiveness of institutional investors lobbying against takeover defenses. Canadian and Australian institutional investors may be on the path towards similar roles.

American institutional investors are less independent, for most private sector workers' pension funds are managed by their employers (Bodie & Davis 2000; Woidtke 2002). Thus, General Motors, IBM, and Northwest Airlines each run pension funds for their employees. Corporate pension funds seem reluctant to vote against the incumbent top management of firms they own – perhaps hoping their pension funds will reciprocate should the need arise (Wahal 1996; Del Guercio & Hawkins 1999; Faccio & Lasfer 2000; Woidtke 2002). This leaves only government employees pension funds and a few pension funds organized by occupation, rather than by employer, to act as genuine guardians of good governance. CalPERS, the California Public Employees Retirement System, and various pension funds for teachers and university professors denounce problematic governance, and often vote against incumbents in proxy contests (Pound 1988). However, civil servants' pension funds can be stymied by

other problems, such as political pressure to favor firms with strong government connections (Romano 1993c; Romano 1993a; Romano 1995), and can suffer governance problems of their own (Lakonishok *et al.* 1991).

But most controlling shareholders in most countries are tycoons or wealthy families (La Porta *et al.* 1999), for independent institutional investors up to the job of challenging corporate insiders are rare outside a handful of English speaking countries (Turner *et al.* 1991). Top insiders who are also large shareholders ought to be less prone to agency problems than the top managers running the widely held firms featured in section 2.2. This is because any drop in shareholder value due to the insider sacrificing value for utility costs him money too – because he is also a shareholder. However, top insiders who are also large shareholders might also be more prone to agency problems than the managers of widely held firms because the former cannot be ejected by shareholder votes or corporate raiders, while the latter can. Modest levels of managerial share ownership seem to mitigate agency problems, but higher levels that precipitate entrenchment appear to magnify agency problems (Morck *et al.* 1988; McConnell & Servaes 1990; Holderness *et al.* 1999, Mueller 2005).

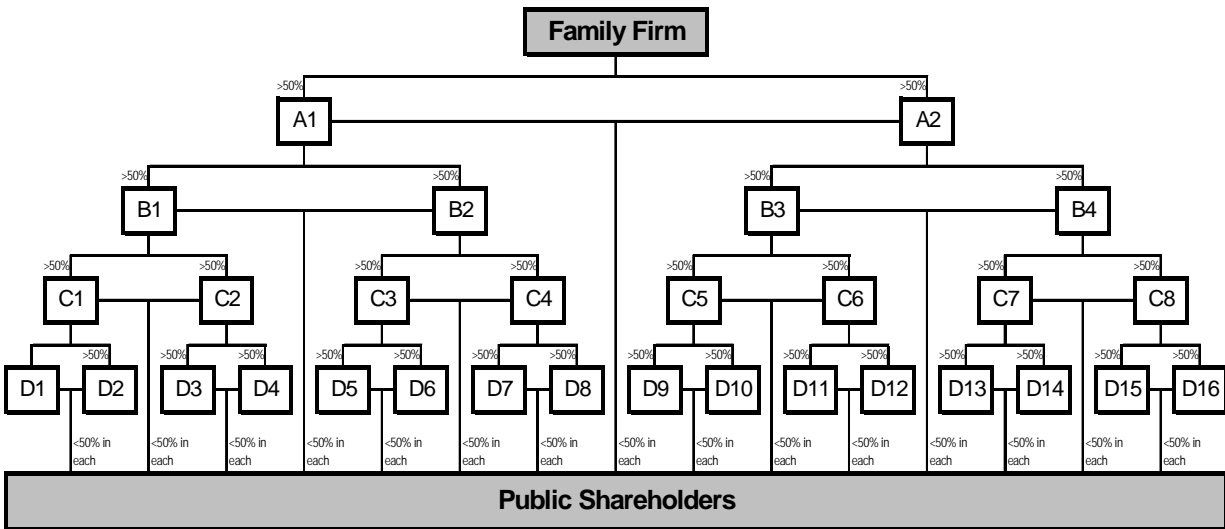
The founders of great family business dynasties are necessarily highly talented business leaders, and that talent may more than make up for any problems associated with entrenchment. Indeed, powerful tycoons may do their countries great service by coordinating so-called “big push” industrialization (Murphy *et al.* 1989), a process that requires the coordinated capitalization of interdependent firms across many sectors of the economy. Rosenstein-Rodan (1943) argues that a modern economy is a complex web of interdependencies, with each firm implicitly relying on hosts of suppliers, customers, and complementary good producers in numerous other industries, and on their suppliers, customers, and complementary goods providers, and so on. This, he argues, means rapid industrialization must be run under central planning, for otherwise early movers are subject to hold up problems, economy of scale mismatches, and problems due to missing industries or insufficient competition in early stage industries.

Morck and Nakamura (2007) argue that the large business groups tycoons assemble in rapidly industrializing countries may reflect “big push” growth in progress. The firms in such a group are usually arranged in a control pyramid, with the tycoon controlling an apex firm that controls other listed firms, each of which controls yet other listed firms, and so on – as illustrated in Figure 2. Actual control pyramids also involve an apex firm, directly controlled by the family, controlling several listed firms, each of which controls several more listed firms, and so on; but are often complicated by crossholdings, control blocks split between multiple parent firms, control by parent firms in more distant tiers, dual

class stock, and numerous other factors. Thus, Figure 3 illustrates an actual business group, that of Italy's Agnelli family.

**Figure 2. An Archetypal Pyramidal Business Group**

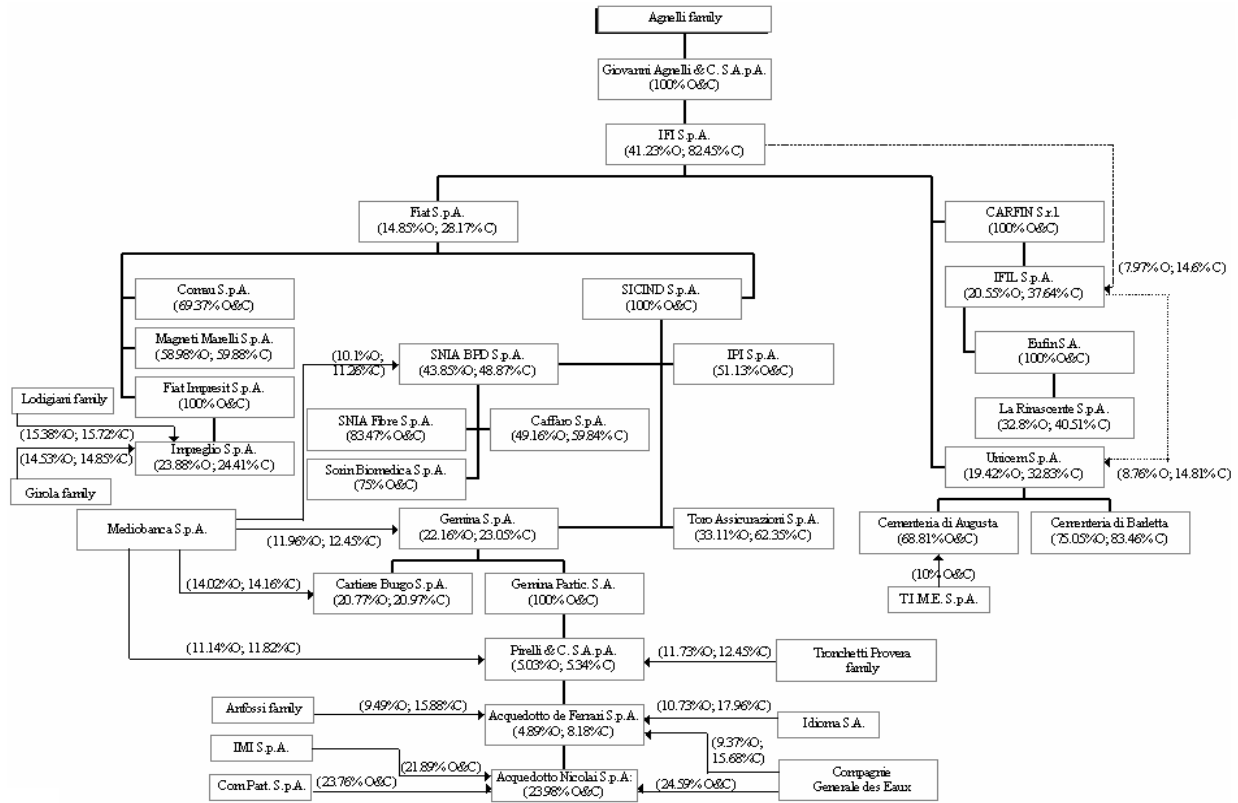
Each box represents a listed firm. Lines connect controlled firms to the firm that controls them or, at the apex of the structure, to the controlling family. Such structures let business families or tycoons magnify control over one firm into control over business groups containing vastly greater assets that, in some cases, amount to sizable fractions of national economies.



Source: Wolfenzon et al. (2005)

**Figure 3. The Agnelli Pyramidal Business Group**

Each box is a separate firm, with lines indicating controlling equity blocks. Figures designated “O” are the family’s actual ownership stake and those designated “C” are the fraction of votes the family controls in the annual general shareholder’s meeting. The group is depicted as it was in the mid 1990s.



Source: Aguinin and Volpin (2005).

These structures can contain dozens, and even hundreds of distinct firms, each drawing energetically on public equity capital but controlled through a dominant voting block held by the firm above it (Bebchuk *et al.* 2000). This structure lets the business group mobilize vast amounts of capital, yet preserves for the controlling shareholder of the apex firm an undisputable rule over every firm in the group. One person in command means the group member firms do not hold each other up, that ventures in new industries can be established as firms in other sectors need them, and that firms forced to operate at inefficient scales can be subsidized via inter-corporate income shifting, or tunneling (Johnson & et al. 2000).

Consistent with a “big push” coordination role, pyramidal groups in emerging economies tend to be extraordinarily widely diversified, with one firm in virtually every major sector (Khanna & Yafeh 2007). Business group member firms also tend to be more profitable, on average, than independent

firms in emerging markets (Khanna & Palepu 2000b, a; Khanna & Rivkin 2001; Khanna & Yafeh 2005), perhaps reflecting their central role in “big push” industrialization. Finally, some Indian business groups appear to take a leading role in setting up new firms in new industries (Khanna & Palepu 2005), and similar patterns are evident elsewhere (Almeida & Wolfenzon 2006).

However, the contribution of pyramidal business groups to rapid industrialization is evident only in Meiji Japan (Morck & Nakamura 2007). Further evidence from other countries is needed to assess the generality of this theory validating despotic corporate governance. Meanwhile, other potential benefits of a controlling shareholder in emerging market economies include reputational capital (Khanna & Palepu 2000b) and an ability to sidestep weak institutions and commonplace market failures by controlling firms on both sides of an otherwise risky transaction (Khanna & Yafeh 2005).

## **4.2 SIMPLE DESPOTS**

This benign view of despotic corporate governance may well be valid in some countries, or even in all countries at a certain stage of development where “big push” industrialization is needed. But there is ample empirical evidence that despotic corporate governance is often malign, and can seriously retard living standards and institutional development.

First, intelligence need not run reliably in families and brilliant tycoons, whose sweeping governance power is entirely appropriate, may leave their empires to sons and grandsons of decidedly less ability. Consistent with this, studies using data from developed economies find family control blocks in the hands of heirs correlating with depressed firm performance (Morck *et al.* 1988; Villalonga & Amit 2006). Event study evidence from successions in family firms confirms that control passing to an heir causes poor performance (Smith & Amoako-Adu 2005; Perez-Gonzalez 2006), as does careful instrumentals variables estimation (Bennedsen *et al.* 2007). This appears to be a lesser problem in many developing economies (Khanna & Yafeh 2007) – perhaps because arranged marriages let business families breed for talent (Mehrotra *et al.* 2010), or perhaps because wealthy heirs can readily substitute connections for talent in more corrupt economies (Krueger 2002; Morck & Yeung 2004; Fogel 2006), or have unique (in their countries) access to good education and management training.

Second, business tycoons and families often control firms without actually owning many of their shares. They usually accomplish this by using dual class shares, pyramiding, or both. Regardless, this greatly expands the scope for agency problems and non-value-maximizing corporate governance.

Dual class shares are the rotten boroughs of corporate finance. A dual class equity structure means a firm has two kinds of shares: superior voting shares, owned by the insiders, their friends, and

their relatives, give their owners 10, 100, or more votes per share; and inferior-voting shares, owned by outside investors, give their owners one, or often even no votes per share. Examining U.S. dual class firms, Gompers et al. (2010) report that average q ratios fall sharply with the extent to which their insiders voting rights exceed their actual ownership stake. Other evidence, including event studies around the establishment of dual class structure and changes in the relative importance of different share classes, suggests that dual class equity causes depressed shareholder value (DeAngelo & DeAngelo 1985; Jarrell & Poulsen 1988; Smith & Amoako-Adu 1995; Amoako-Adu & Smith 2001; Nenova 2003).

Dual class shares barred firms from graduating from the NASDAQ or MAMEX to the NYSE, so up-and-coming US firms tended to avoid them. However, dual class equity is more common in other countries such as Canada (Smith & Amoako-Adu 1995; Amoako-Adu & Smith 2001) and Sweden (Högfeldt 2005). A general trend towards unification of such equity structures is evidenced by the Israeli policy of 1989 that dual class firms unify their equity prior to issue additional shares, (Hauser, and Beni Lauterbach 2004).

In many countries, super-voting shares and inferior-voting shares in the same company trade side by side on the same stock exchange. Zingales (1994) explains an 80% premium for super-voting shares on the Milan stock exchange as reflecting the extensive private benefits Italy's legal system permits controlling shareholders to extract. Nenova (2006) shows that superior voting rights command higher premiums in more corrupt economies, suggesting that more efficient and public shareholder-friendly legal and regulatory systems curtail private benefits of control.

Pyramiding lets a controlling shareholder leverage a modest fortune into control over firms worth vastly more. For example, a family might own fifty percent plus one share of Firm A, with small shareholders owning the remainder of its stock. Firm A might then own fifty percent plus one share of Firm B, again with small shareholders owning the remainder. The family can thus appoint Firm A's board, control of which lets the family also appoint Firm B's board. But the family has only 50% of a 50% stake in Firm B, and thus really only owns 25% of firm B. To see this, consider what happens if Firm B's value drops \$1M. This causes Firm A's stock in firm B to drop in value by \$500K, and this causes the family's wealth to drop by \$250K. This precisely replicates what would happen if the family owned a 25% stake in B directly.

Actual pyramids can involve much longer chains of firms controlling firms, and those reinforced with super-voting shares, golden shares, and the like can include links with far less than 50% control. For example, in the 1990s a branch of the Canadian Bronfman family directly controlled Broncorp Inc., which controlled HIL Corp. with a 19.6 percent stake. HIL owned 97 percent of Edper Resources, which

owned 60 percent of Brascan Holdings, which owned 5.1 percent of Brascan, which owned 49.9 percent of Braspower Holdings, which owned 49.3 percent of Great Lakes Power Inc, which owned 100 percent of First Toronto Investments, which owned 25 percent of Trilon Holdings, which owned 64.5 percent of Trilon Financial, which owned 41.4 percent of Gentra, which owned 31.9 percent of Imperial Windsor Group (Morck *et al.* 2000).

This gives rise to two sorts of potentially severe agency problems. First, if the brothers were to sacrifice \$1M of Imperial Windsor's assets to obtain a private benefit, this would reduce the value of Gentra by  $31.9\% \times \$1M = \$399K$ , which would reduce the value of Trilon Financial by  $41.4\% \times \$399K = \$165K$ . Multiplying ownership stakes all the way back shows the personal financial cost to the family would be \$300, or 0.03 percent of the \$1M total cost of private benefit. If the family had no concern for public shareholders, a private benefit worth \$301 would outweigh the \$1M loss for Imperial Windsor.<sup>9</sup> Since the family fully controls this firm by dint of controlling its parent, and its parent's parents all the way up through the control chain, they could do this if they so chose.

Second, pyramiding can tempt a controlling shareholder to favour one firm in the pyramid over another. For example, a business deal between Imperial Windsor and HIL that caused the former to lose \$1M, costing the family \$300, and the latter to gain that amount, increasing the family's wealth by 19.6% of \$1M or \$196,000. Since the family controls the boards of both, it could easily instruct both boards to approve the one-sided deal. Such transactions are variously called transfer pricing, income shifting, related party transactions, or tunnelling; and can involve the sale of goods, services, insurance, or financial assets at artificial prices that shift wealth from one firm to the other.

Tunnelling is entirely legal in many countries, and is considered a routine business practice. In many Western Europe, Latin America, and much of Asia the practice is either explicitly legal or essentially unregulated (Johnson & et al. 2000). Other countries regulate related party transactions (Djankov *et al.* 2008). For example, Israel requires approval by one third of disinterested shareholders before group firms can proceed with substantial related party transactions. In Canada, large related party transactions must be disclosed and can require approval by the majority of disinterested shareholders in a vote. Empirical studies reject pervasive tunnelling in Canada (Tian 2006) and Western Europe (Faccio & Lang 2002); but not in India (Bertrand *et al.* 2002), Korea (Bae *et al.* 2002), or other East Asian economies (Claessens *et al.* 2002; Claessens *et al.* 2006).

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<sup>9</sup> This example is illustrative only of the potential for agency problems. Stangeland et al. (1995) find no evidence of governance problems in this business group during this period.



Shares not part of the control blocks holding the structure together are sold to outside investors, and are discounted appropriately for the agency problems expected in each firm. This differs across firms in the group, for it depends on the controlling family's likely propensity to use the firm to generate private benefits of control, and on whether the firm is more likely to give or receive in tunneling.

### **4.3 EFFICIENT DESPOTISM**

Top corporate insiders whom shareholders cannot fire are said to be *entrenched* (Stulz 1988). The tycoons and business families who control pyramidal business groups command control blocks in every firm in the pyramid, and so are entrenched. But so are the CEOs of widely held US firms who rig their corporate charters with staggered boards or who reincorporate their firms into states that curtail hostile takeovers.

A degree of entrenchment might not be inefficient. First, Almazan and Suarez (2003) argue that an efficient compensation contract for top managers might provide a degree of entrenchment because job security is a component of compensation along with salary, bonus, and options. Indeed, job security might be a desirable way of compensating CEOs when taking risks with very long-term payoffs maximizes share value. Second, if interpersonal utility comparisons are permitted, an entrenched insider might gain so much utility from controlling a great corporation that it outweighs the disutility her blunders inflict upon others. Stulz (1988) models how she selects what fraction of her firm to sell to outside shareholders and what level of monitoring and control mechanisms to install so as to balance her marginal utility of wealth against the marginal utility she gains from control. In such a situation, altering the rules to let shareholders remove her would not be a Pareto improvement, and could only be justified on distributional grounds. Finally, an exceptionally able and socially minded insider might deliver more efficient capital allocation, all else equal, if freed from constraints imposed by less insightful public shareholders.

## **5. CORPORATE GOVERNANCE AND CAPITALISM**

The division of labor underlies capitalism's success: just as people specialize in specific trades, firms specialize in core business activities. Capitalism achieves economies of scale, despite specialization, by mobilizing vast pools of public savings to capitalize efficiently large efficiently specialized firms run by people with the specialized abilities.

Capitalism thus entrusts top executives with huge amounts of “other people’s money” and commands they be trustworthy agents that maximize the value of the pool of capital under their stewardship. That is, without regard for their own utility, they must identify and undertake ventures that earn genuinely positive economic profits exploiting new markets, technologies, business models, or other opportunities. Clearly, such expertise deserves compensation, but its appropriate magnitude and form are ill understood at present. If the top managers are inefficiently selected or incentivized, and attend too much to their own utility rather than their investors’ wealth, we have an agency problem.

Firm performance aggregates to economy performance, so how top corporate executives are selected and incentivized matters for productivity, jobs, and tax-financed public goods and services. One such public service is the evenhanded enforcement of cost effective regulations to efficiently select and incentivize top executives so firms are credibly trustworthy, and their stock are viable investments. The voters of virtually all major democracies have elected governments that mandate standardized accounting information and criminal penalties for releasing false information. This imposes compliance costs on firms, reducing investors’ returns; but helps reassure investors that the firm is run in a trustworthy way. Governments that get this tradeoff right mobilize their savers wealth efficiently and optimize their citizenries’ potential well-being.

Most major democracies reward unfaithful corporate insiders with fines or jail for a range of excessively self-interested behavior. However, the range varies across countries, as does the definition of good faith. A CEO loading corporate assets into a truck to be sold for personal gain violates the law almost everywhere. Insider trading is illegal in an increasing number of countries, though enforcement varies. In the United States, and a few other countries to a lesser extent, investors sue top corporate insiders for failing to run their firms well. Good faith in the United States and United Kingdom traditionally meant making reasonable decisions aimed at maximizing long-term shareholder value (Romano 1993b), but other countries define it otherwise. In Canada, top corporate officers and directors have a duty only to the legal person of the corporation, not to its shareholders or any other stakeholders (Lee 2005). In Germany, their duty is to balance the interests of shareholders against those of all others with a stake in the firm – creditors, workers, managers, communities, the environment, and so on (Fohlin 2005).

Over the past decades, US corporate governance laws and regulations have grown progressively less interested in shareholder value (Bebchuk 2007). Courts in many American states now require top managers to balance the interests of all stakeholders, let top managers protect themselves from shareholder democracy with poison pills, staggered boards, and other entrenchment devices. Some

students of corporate governance see this arising from a yet deeper agency problem (Bebchuk & Cohen 2003; Bar-Gill *et al.* 2006).

In a democracy, the people entrust politicians and top civil servants with command over the capital assets of the government, rulemaking authority, and police powers of enforcement to advance the public interest. In the framework of agency theory, these public sector managers are agents of the people, much as top corporate managers are agents of shareholders. Politicians and top civil servants also have utility functions, and are as prone to maximize them as anyone else (Krueger 1974). If public officials put personal utility ahead of the public interest, the public sector too has an agency problem (Stulz 2005).

Just as shareholders can sell to a raider, the voters can turn out errant leaders in elections and force civil service rationalizations in referendums. But just as corporate governance can, in reality, drift far from efficient value maximization; government can lose sight of the public interest. Indeed, the two sorts of agency problem may well reinforce each other: CEOs might use shareholders' money to support politicians who grant them greater leeway in using shareholders' money as they will; while politicians might use taxpayers' money to support inefficiently governed firms that open competition would otherwise destroy. Market failure begets government failure, which begets more market failure in an accelerating race to the bottom to drain away investor wealth and the public good (Morck, Wolfenzon and Yeung 2005).

As with corporate governance, different countries at different times use different institutions to check public officials' all too human self-interest. Again, as with corporate governance, different systems have different strengths and weaknesses, and the optimal system has yet to identify itself (Mueller 2006b). The genuine marvel is perhaps that capitalism and democracy work as well as they do, given this shared internal contradiction. Their vitality suggests that economists may underestimate the strength and resilience of less appreciated checks on self interest – perhaps moral sentiments long constrained most agents' self-interest as effectively as Smith (1762) claims; though religion and culture can also constrain economic and financial development (Stulz 2005). Even more remarkably, such forces may well continue to gather force even now, amid the cynical sophistication of the 21<sup>st</sup> century (Mueller 2009).

The development of institutions surrounding corporate governance is nonetheless clearly incomplete, for most countries employ regulations that are both costly and largely ineffective (La Porta *et al.* 2006). This may well reflect lobbying by corporate insiders in mature firms, who benefit directly

from the freedom to use their investors' money as they please; or by financial advisors, lawyers, accountants, and others who benefit indirectly from regulatory complexity and opacity.

In this sense, corporate governance is where political science was a century or two ago. Hereditary power entrusted to business family dynasties remains the default form of governance in most countries, and the limited shareholder democracy on offer often works poorly. Intelligent observers can, with straight faces, argue that despots serve some economies better than democrats. Competition between governments for capital and skilled labor to tax may well induce continually stronger and more efficiently provided shareholder rights (Tiebout 1956; Buchanan 1965). But lobbying by powerful top corporate insiders might equally well induce a "race to the bottom" in corporate governance (Bebchuk & Ferrell 2000) among governments.

Here we see grounds for optimism. Institutions arose in other areas to promote social welfare at the expense of previously seemingly immovable elites. Democracy is a more prevalent now than a century ago; courts in the industrial democracies are also arguably less tolerant of corruption in high places and academia is more open to new ideas. In these is discernable a well-beaten path towards reform that corporate governance might also follow (Morck 2008). Thus, calls for boards to designate a lead independent director evoke political parallels in the "leader of the loyal opposition", whose duty of loyalty to democracy requires a continual criticism of government policies. Calls for more and stronger independent directors likewise seem bent on injecting more argument and dissent into boardrooms, rather like the constructive argument the adversary system evokes in Common Law courtrooms which, somewhat inexplicably, appear to deliver better decisions in cases involving business disputes than do the inquisitorial proceedings in legal systems descended from the Napoleonic code (Gennaioli & Shleifer 2007). These efforts to induce dissent in corporate boardrooms are likely to be unpopular with some CEOs, just as discussants and referees were initially controversial in academia. But opposition politicians, counterarguments in court, and referees do seem to deliver better decisions, and so might corporate boardrooms subjected to more shareholder democracy and accountability.

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