



# NATIONAL SYSTEMS OF CORPORATE GOVERNANCE

Eric R. Gedajlovic and Daniel M. Shapiro

*Corporate governance reform is at the top of the agendas of many national governments and international agencies. A number of reports have described codes, or principles of "best practice." Unfortunately, while there is a broad consensus that effective corporate governance is important, the definition of what constitutes effective governance remains elusive. In this paper, we describe how a nation's governance system reflects both economic and society-specific contextual factors. In doing so, we highlight key structural differences and similarities across the governance systems of Canada, France, Germany, Japan, the United States, and the United Kingdom, and report evidence which indicates that the frequently made distinction between network and market-oriented systems significantly understates the heterogeneity of governance systems. In closing, we offer some comments regarding both the progress towards and the advisability of harmonizing national systems of corporate governance. © 2001 John Wiley & Sons, Inc.*

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## Introduction

Who should control a nation's largest corporations? For whose benefit? To what ends? These three questions lie at the heart of the ongoing debate among business leaders, public policy makers, academics, shareholders, and various other stakeholder groups in many countries around the world. Issues pertaining to effective corporate governance, once limited to individual companies, are now integral to national policy debates over competitiveness and macroeconomic stability. It is now widely appreciated that deficiencies in a society's corporate governance system can have far-reaching consequences. For instance, both the OECD<sup>1</sup> and the World Bank<sup>2</sup> have taken the position that ineffective corporate

governance was one of the root causes of the 1997 Asian financial crisis.

As documented in Table I, corporate governance reform is truly a global phenomenon. Reports identifying needed corporate governance reforms have been issued in no fewer than 25 nations across every region of the world, spanning developed, developing, and transition economies. Concurrent with this spate of national reports are several ongoing initiatives by international agencies such as the World Bank, the IMF, and the OECD to identify principles of "best practice" that may serve as the basis for the harmonization of presently diverse national systems of corporate governance (Table II). According to this view, the failure to adopt best practice governance norms increases the cost of capital for

**TABLE 1** Country Specific Reports and Statements on Corporate Governance Practices<sup>a</sup>

<i>Country</i>	<i>Document</i>	<i>Date</i>
Australia	AIMA Guide & Statement of Best Practice	1995
	Bosch Report	1995
Belgium	Cardon Report	1998
	Banking and Finance Commission Report	1998
Brazil	Code of Best Practice of Corporate Governance	1999
Canada	The Dey Report	1994
	Five Years to the Dey	1999
France	Vienot I Report	1995
	Vienot II Report	1999
Germany	AFG-ASFFI Recommendations on Corporate Governance	1999
	DSW Guidelines	1998
	Corporate Governance Rules for German Quoted Companies	2000
Greece	Principles on Corporate Governance in Greece	1999
Hong Kong	Code of Best Practice	1999
India	Kumar Mangalam Report (Draft)	1999
Ireland	Corporate Governance, Share Option and Other Incentive	1999
	Scheme Guidelines	
Italy	Draghi Commission	1998
	Code of Conduct	1999
Japan	Corporate Governance Principles (Interim Report)	1997
	Corporate Governance Principles - A Japanese View	1998
Korea	Code of Best Practice for Corporate Governance	1999
Kyrgyz Republic	Model Charter of a Shareholding Society of Open Type	1997
Malaysia	Finance Ministry, Report on Corporate Governance	1999
Mexico	Código de Mejores Practicas Corporativas	1999
The Netherlands	Peters report	1997
Portugal	Recommendations on Corporate Governance	2000
South Africa	King Report	1994
Spain	Código de Buen Gobierno	1996
	Círculo de Empresarios	1998
Singapore	Amendments to Listing Manual and Best Practices Guide	1998
	(Singapore Stock Exchange)	
Sweden	Skandia's Corporate Governance Policy	1995
Thailand	The Roles, Duties and Responsibilities of the Directors	1997
	of Listed Companies.	
United Kingdom	Cadbury Report	1992
	Greenbury Report	1995
	Hampel Report	1998
	The Combined Code	1998
United States	Report of the Blue Ribbon Committee	1999
	Business Round Table Statement on Corporate Governance	1997

<sup>a</sup> Sources: Adapted from World Bank (<http://www.worldbank.org>) and European Corporate Governance Network (<http://www.ecgn.ulb.ac.be/>).

a nation's firms because poor governance prevents investors from efficiently bearing risk.<sup>3</sup>

Such international initiatives appear at least partially based upon the dual premise that a significant convergence of national systems of corporate governance is both desirable and, to some degree, inevitable as a consequence of the globalization of markets. Unfortunately, while there is a broad consensus that effective corporate governance is important, the establishment of a single set

of best practice principles, or even the definition of what constitutes effective governance, is much more contentious and elusive. Since the world's largest businesses are "markets for influence,"<sup>4</sup> in which a wide variety of stakeholders exert influence and have a vested interest, effective governance solutions require a consideration of politics, law, sociology, and history, in addition to economics and finance. The noneconomic dimensions of corporate governance are now recognized

**TABLE II** International Reports and Statements on Corporate Governance Practices<sup>a</sup>

<i>Body</i>	<i>Document</i>	<i>Date</i>
Organization for Economic Cooperation and Development (OECD)	OECD Principles of Corporate Governance	1999
The Business Sector Advisory Group on Corporate Governance	Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets (i.e. the "Millstein Group Report")	1998
The World Bank	Corporate Governance: A Framework for Implementation	1999
International Monetary Fund (IMF)	Good Governance: The IMF's Role	1997
Commonwealth Association for Corporate Governance (CAGG)	Principles for Corporate Governance in the Commonwealth: Towards global competitiveness and economic accountability	1999
European Association of Securities Dealers Automated Quotation (EASDAQ)	European Association of Securities Dealers Automated Quotation (EASDAQ) Rule Book	2000
APEC	Corporate Governance in APEC: Rebuilding Asian Growth	1998
European Bank for Reconstruction and Development (EBRD)	Sound Business Standards and Corporate Practices: A Set of Guidelines	1997
Centre for European Policy Studies (CEPS)	Corporate Governance in Europe—Recommendations	1995
International Corporate Governance Network (ICGN)	Statement on Global Corporate Governance Principles	1999
European Corporate Governance Network (ECGN)	Preliminary Report to the European Commission	1998

<sup>a</sup> Sources: Adapted from World Bank (<http://www.worldbank.org>) and European Corporate Governance Network (<http://www.ecgn.ulb.ac.be/>).

as integral to the governance debate even by those, such as U.S. Federal Reserve Chairman Alan Greenspan, who advocate the convergence of national systems of corporate governance on a single best practice solution:

Corporate governance that defines the distribution of power, of course, invariably reflects the most profoundly held societal views of the appropriate interaction of parties in business transactions... Accordingly, full convergence across countries... is a very difficult task.<sup>5</sup>

Thus, notwithstanding the effects of the globalization of markets and efforts by international agencies to promote convergence, the national institutional structures in which any corporate governance solution must be embedded remain formidable obstacles for global convergence. Since a nation's governance system is a product of both global forces for convergence and local forces for variation, the evaluation and comparison of national systems of

corporate governance is more complex than is frequently understood.

In this paper we offer a perspective on national governance systems that is grounded in economic theory but is informed by noneconomic contextual considerations. We begin our discussion by describing the essential corporate governance problem as a classic principal-agent problem insofar as shareholders rely on professional managers to operate the corporation on their behalf. We then describe the various constraints, internal and external, to a firm that can be employed to limit management's ability to exercise their discretion at the expense of shareholders and explain why a consideration of these contextual considerations is essential to understanding how any system of corporate governance operates.

Subsequently, we examine the national corporate governance systems of Canada, France, Germany, Japan, the United Kingdom, and the United States. We identify both similarities and differences across these countries in terms of the constraints placed upon man-

agers and more generally in terms of the broad institutional context in which stakeholder relations are embedded. Our analysis leads to the conclusion that material differences exist between any two countries—even countries such as the United States and the United Kingdom, which are frequently depicted as operating equivalent governance systems. The differences and similarities we highlight between nations illustrate the precarious nature of attempting to categorize national systems of corporate governance solely on the basis of general philosophical tendencies. In support of this conclusion, we summarize the results of two recent studies<sup>6</sup> that suggest that unique country-specific variants exist across countries that superficially appear to be using the same governance mechanisms.

Lastly, we describe some implications of this research regarding both the progress towards, and the advisability of the convergence of national systems of corporate governance.

#### Corporate Governance from an Agency Perspective

Agency theory suggests that the interests of principals and agents will often conflict. In the absence of either appropriate incentives or sufficient monitoring, agents will be able to exercise their discretion to the detriment of principals.<sup>7</sup> In the context of the modern corporation, agency theory has been applied to the relationship between managers (agents) and shareholders (principals). In terms of corporate governance, the standard agency argument is that shareholders want the firm to maximize profits, but their designated agents may have neither the interest, nor the incentive to do so. Corporate behavior and performance therefore depend in part on the ability of shareholders to effectively monitor and control managers. Agency theorists term the costs associated with monitoring and controlling managers, as well as the costs of failing to do so effectively, as “agency costs.”

The academic literature has identified two broad manifestations of managerial discretion that may result in agency costs. The first is that managers sometimes engage in short-run cost augmenting activities designed to enhance their nonsalary income, or to provide other forms of

on-the-job benefits. Such behavior reduces corporate profits by increasing costs. Agency theorists argue that the managerial tendency to cost-pad is inversely related to their ownership stake in the firm. As a manager's right to a firm's profit stream decreases, the incentive to extract proceeds from the firm in the form of salary and perquisites, rather than in the form of any claim they may have against corporate profits, increases.<sup>8</sup>

A second manifestation of managerial discretion leading to agency costs occurs when managers indulge their needs for power and prestige by making long-run strategic choices designed to maximize corporate size and growth rather than corporate profits. Economists have long argued that managers derive many personal benefits from such “empire building.”<sup>9</sup> For example, managers may have an economic incentive to value growth over profitability since executive pay is commonly a function of hierarchical positioning and span of control rather than organizational performance.<sup>10</sup> Similarly, it is often the case that mid-line managers are rewarded by promotion resulting in another bias favoring growth over profitability.<sup>11</sup> Taken together, these factors suggest that managers have a bias for growth that may not be in the best interests of shareholders as managers pursue increasingly less profitable opportunities leading first to diminishing marginal profitability, and if growth is pushed too far, diminishing average profitability.<sup>12</sup>

A related and commonly cited example of managerial self-interested strategizing occurs when managers over-diversify, which results in lower, but more stable profit streams. Such actions benefit managers by lowering their own employment risk (due in part to a lower risk of bankruptcy), but at the expense of already well-diversified shareholders that suffer from lower returns.<sup>13</sup> In such situations, profits are reduced as projects are undertaken whose economic returns to shareholders are poor, but whose benefits accrue to managers in terms of enhanced job security.

Although short-run cost augmentation and self-interested strategizing reflect two quite different processes, they both reflect the fundamental premise of agency theory that where managerial discretion is present, it will be exercised at the expense of shareholders.

### Constraints on Managerial Discretion

How are managers monitored and prevented from exercising their discretion and pursuing paths of cost augmentation, or self-interest strategizing? Agency theorists contend that the most direct way of controlling managers is through a dominant shareholder who holds a large block of shares since such a blockholder has both the incentive and ability to effectively monitor management.<sup>14</sup> The incentive for a corporate blockholder to monitor managers is high because they have a claim on the firm's residual profit. At the same time, the ability of a major shareholder to monitor managers is high because the blockholder can often exercise control over the company's Board of Directors. In contrast, when shareholdings are widely diffused, no shareholder has either the incentive or the ability to monitor their managerial agents. In such circumstances, managerial agents may be afforded the discretion necessary to pursue their own agendas. Thus, agency theorists view large blockholders, or otherwise concentrated share ownership as a potentially powerful constraint on managerial discretion.<sup>15</sup>

Flowing from this reasoning, research grounded in agency theory often makes the simplifying assumption that managerial discretion is essentially a negative function of ownership concentration. On the other hand, it is undoubtedly the case that many factors other than concentrated ownership have a bearing on the degree of discretion afforded managers. For instance pressures from increasingly global and transparent product and capital markets, the presence of powerful stakeholders and NGOs, as well as the many formal and informal expectations that societies place on their corporations all represent potentially powerful checks on managerial discretion. In other words, the ability of managers to engage in self-interested behavior at the expense of shareholders is not simply a function of a firm's ownership structure, but is determined by a vector, or multiplicity of economic and noneconomic factors.

There is much literature devoted to an analysis of the various constraints on managerial discretion and their impact on the power of top management.<sup>16</sup> These constraints may be classified as internal or external.<sup>17</sup> Internal constraints largely emanate from the Board of

Directors, and are exercised on behalf of shareholders (owners). Internal constraints reflect the composition and powers of the Board, including the ease by which shareholders can appoint or remove Board members, and the rules governing voting. External constraints pertain to the role of markets in monitoring and disciplining managers. The most widely noted external constraint is the market for corporate control,<sup>18</sup> but other market-related constraints arise from managerial labor markets, product markets, and financial markets.

Consider the internal constraint represented by the Board of Directors and its composition. A Board that represents shareholder (or stakeholder) interests can effectively monitor managers by virtue of its proximity to sources of information. Also, because the Board of Directors is a relatively small body, monitoring costs are low. Needless to say, the efficacy of internal constraints is dependent on the Board acting in the interests of shareholders (or stakeholders), an assumption that may not always be justified. Unless board members are significant shareholders, their incentive to monitor is low and will not approach that of a dominant, or majority shareholder.<sup>19</sup> In countries where workers or other stakeholders are represented on the Board, the incentive as well as the ability to monitor can also be quite high.

An essential characteristic of internal constraints is that the responsibility for monitoring falls to insiders (e.g., owners, or the Board) who are directly charged with the responsibility for corporate governance. What is common to the external constraints is that they rely on a variety of markets or market-based incentives to align the competing interests of shareholders and managers and thus, when effective, render monitoring of managers unnecessary. In the case of external constraints, shareholders are essentially transferring monitoring responsibility to markets. In the case of the market for corporate control, managers who do not maximize returns to shareholders will see their firms acquired and themselves displaced in favour of more proficient managers.

### Constraints in a Cross-National Context

The previous discussion suggests a simple taxonomy for comparing national systems of cor-

porate governance. Figure 1 categorizes governance systems in terms of their relative reliance on internal and/or external constraints on managerial discretion. The taxonomy illustrates a common distinction between two competing systems of corporate governance: the Anglo-American model and that of Western Europe and Japan.

A hallmark of Anglo-American governance is the utilization of external and market-oriented constraints and the relative weakness of internal constraints on managerial discretion. The Anglo-American system is typically characterized as one in which ownership is widely distributed among individual or institutional shareholders, leading to the possibility of entrenched managers. Managers are disciplined by financial incentives such as incentive contracts or by the threat of losing their position subsequent to a takeover of their firm.

In contrast, the governance philosophies of Western Europe and Japan emphasize the use of internal constraints and the relative absence of external constraints. In countries such as Germany and France, ownership is more highly concentrated in the hands of stakeholders, usually banks or other companies. The resulting absence of an active market for corporate control means that supervision and control of managers is largely the responsibility of the corporate insiders.

The contrast between the United States and United Kingdom, on the one hand, and Germany and Japan, on the other, has led one researcher to conclude that corporate control practices tend to represent two distinct philosophies.<sup>20</sup> Many other analysts have arrived at the same conclusions, and have used rubrics such as "networked" versus "high tension" systems,<sup>21</sup> Type I and Type II systems<sup>22</sup>; "insider" and "outsider" systems,<sup>23</sup> "bank-oriented" and "market-oriented" systems,<sup>24</sup> and "stakeholder" and "shareholder capitalisms"<sup>25</sup> to distinguish between the two varieties of national governance systems.

The type of governance system observed in Canada illustrates the difficulties encountered when attempting to categorize national systems of governance in terms of two distinct philosophies. Canada is a country that does not easily fit into such a simple dichotomous world. As a small open economy with fairly active markets for corporate control, Canadian managers face powerful outside constraints on their discretion. However, the concentrated nature of corporate ownership in Canada indicates that Canadian managers also face powerful internal constraints. In fact, in Canada, both external and internal constraints are relied upon through the combination of an open economy, a relatively active market for corporate control and large numbers of closely held firms.

		EXTERNAL CONSTRAINTS	
		STRONG	WEAK
INTERNAL CONSTRAINTS	STRONG	CANADA	FRANCE GERMANY JAPAN
	WEAK	UNITED STATES  UNITED KINGDOM	

FIGURE 1. Systems of governance and constraints on managerial discretion.

In our view, the fact that Canada cannot be easily characterized as following one of the two dominant corporate governance philosophies illustrates the problematic nature of distinguishing between national systems of governance on the basis of two divergent philosophical tendencies. Such a basic distinction offers some useful insights, but fails to address many material differences in the governance practices in countries sharing the same broad philosophy concerning what constitutes appropriate and effective corporate governance.

In fact, although many common constraints on managerial discretion are operative in developed market economies, within each country a particular nexus of constraints generally emerges. In this respect, many differences between country-specific variants of broadly similar governance systems are as material as differences between competing governance philosophies.

In our view, Figure 1 provides an overly simplistic view of national systems of corporate governance. In addition to the fact that some countries, such as Canada, appear not to conform well to the dichotomy, there are important within-cell differences among the countries. We illustrate these differences in Table III, for six countries: the United States, the United Kingdom, Canada, France, Germany, and Japan. Each element in Table III comprises a distinct topic, well beyond the scope of this paper. While there may be some disagreement about the evaluation of a particular cell, or even which cells are included, our purpose is to illustrate material differences between and within competing general philosophies of corporate governance.

Table III documents a considerable variation across countries in terms of multiple governance dimensions. While the Anglo-American systems are similar in some respects, they differ along other dimensions. The same is true of continental Europe and Japan. Consider, for example, the following differences and similarities in corporate ownership patterns.

In the United States, the United Kingdom and Japan shares in most large firms are relatively widely held, so that the largest shareholder holds a fairly modest ownership stake in the company. On this dimension,

Japan is more similar to the United States and the United Kingdom than to either France or Germany.

In both Anglo-American systems the largest shareholders are increasingly institutions, particularly pension and mutual funds that invest on behalf of individuals.<sup>26</sup> Thus, in both countries, shareholders tend to be passive, or "distant shareholders."<sup>27</sup> However, there are also important differences in terms of the identity of shareholders between the United States and the United Kingdom. Direct shareholders by U.S. households account for 49 percent of shareholdings in that country. In contrast the 21 percent of shares held by UK households is more consistent with the levels found in France, Germany, and Japan. On the other hand, shareholdings by financial institutions constitute 68 percent of outstanding shares in the United Kingdom as compared to 46 percent in the United States.

While Japan's low level of shareholder concentration seems to suggest that it shares much in common with the United States and the United Kingdom, the fact that the largest Japanese shareholders are banks and nonfinancial companies that have business relations clearly distinguishes it from the Anglo-American model. In contrast to the external, arms-length mechanisms used in the United States and the United Kingdom, the widespread practice of reciprocal shareholding between affiliated financial and industrial companies means that their major business partners monitor Japanese managers.<sup>28</sup>

In France, Canada, and Germany, the ownership of firms is more concentrated than in the United States, United Kingdom, or Japan. Ownership concentration is particularly apparent in Germany and Canada, where the majority of large firms have a dominant shareholder. In a clear departure from the situation in either the United States or the United Kingdom, it has been estimated that a single shareholder controls 382 of the 400 largest companies in Canada and the average percentage holding of the largest shareholder in a Canadian corporation is 49 percent.<sup>29</sup> In Germany, some 85 percent of the largest firms have a dominant shareholder with an ownership stake exceeding 25 percent<sup>30</sup> and the average percent-

**TABLE III** A Multidimensional Comparison of National Systems of Corporate Governance

<i>Governance Dimension</i>	<i>United States</i>	<i>United Kingdom</i>	<i>Canada</i>	<i>France</i>	<i>Germany</i>	<i>Japan</i>
Average % Shares Held By Largest Shareholder <sup>a</sup>	19%	21%	49%	47%	68%	15%
% Shares held by <sup>b</sup>						
<i>Financial Institutions</i>	46%	68%	45%	8%	30%	44%
Banks	7%	10%	NA	4%	10%	28%
Insurance Companies, Pension & Investment Funds	40%	58%	NA	4%	20%	16%
<i>Non-Financial Sector</i>	54%	32%	NA	92%	70%	56%
Non-Financial Companies	Minimal	1%	NA	58%	42%	24%
Individuals	49%	21%	NA	19%	15%	24%
National & State Governments	Minimal	1%	Minimal	4%	4%	1%
Foreigners	5%	9%	Very high	11%	9%	7%
Board Structure	1 Tier	1 Tier	1 Tier	Typically 1 Tier	2 Tier	Very Large 1 Tier
Board Composition	Managers Outsiders	Managers Outsiders	Owners Managers Outsiders	Owners Workers	Owners Workers	Manager
Role of Financial Institutions	Creditor	Shareholder Creditor	Creditor	Creditor	Shareholder Creditor Advisor	Shareholder Creditor Business Partner Restructurer
Market Capitalization as a % of Gross Domestic Product (1996) <sup>c</sup>	114%	142%	86%	49%	28%	66%
Corporate Disclosure	Comprehensive	Comprehensive	Comprehensive	Limited	Very Limited	Limited
Rating of Accounting Standards Regarding Disclosure <sup>d</sup> (100 is High)	71	78	74	69	62	65
Creditor Rights <sup>e</sup> (4 is high)	1/4	4/4	1/4	0/4	3/4	3/4
Shareholder Rights <sup>f</sup> (6 is High)	5/6	5/6	5/6	2/6	1/6	4/6
Rule of Law Index <sup>g</sup> (10 is High)	10	8.6	10	9	9.2	9
Market for Corporate Control	Very Active	Very Active	Active	Limited	Limited	Very Limited



**TABLE III** A Multidimensional Comparison of National Systems of Corporate Governance (*continued*)

Governance Dimension	United States	United Kingdom	Canada	France	Germany	Japan
Executive Compensation <sup>a</sup> (millions of dollars)	1.35 total 45 incentive	.67 total .10 incentive	.67 total .17 incentive	.57 total .07 incentive	.53 total .06 incentive	.49 total .00 incentive

<sup>a</sup>*Sources:* Gedajlovic ER, Shapiro DM. Management and ownership effects: evidence from five countries. *Strat Mgt J* 1998;19: 533-553. Gedajlovic E, Shapiro, DM. Blockholder and institutional ownership in Japan. *Proceedings of the International Eastern Academy of Management Conference*; 1999; Prague, Czech Republic.

<sup>b</sup>*Sources:* For all countries except Canada, Maher M, Andersson T. Corporate governance: effects on firm performance and economic growth. Paris: OECD; 1999. Canadian figures were obtained from various journalistic sources.

<sup>c</sup>*Source:* Maher M, Andersson T. Corporate governance: effects on firm performance and economic growth. Paris: OECD; 1999. Canadian figures were obtained from various journalistic sources.

<sup>d</sup>*Source:* As evaluated by the Center for International Financial Analysis & Research.

<sup>e</sup>*Sources:* Scale developed by La Porta R, Lopez-de-Silanes F, Shleifer A, Vishny, RW. Law and Finance. *J Pol Econ*, 1998 which measures the extent to which the rights of creditors are protected and exercisable under corporate and bankruptcy law.

<sup>f</sup>*Source:* Scale developed by La Porta et al, *ibid* which measures the extent to which minority shareholder rights are protected and exercisable under Company Law, or Commercial codes.

<sup>g</sup>*Source:* Assessment of law and order tradition of a country by the *International Country Risk Guide*.

<sup>h</sup>*Source:* The Economist, November 27, 1999.

age of shares held by the largest shareholder is 68 percent. German banks play an important role in the German economy. German banks typically hold both large debt and equity positions in that nation's largest corporations. The influence of German banks is augmented even further by the fact that shareholders typically deposit their shares with these financial institutions. The banks collect dividends for the individual investor, and are given the shareholder's proxy. This contributes to a relatively high degree of ownership concentration.

In contrast to the structure of corporate ownership in Germany, bank ownership is very low in France, but the role of the government as owner is more important. Although the government does not own the majority of French firms, and although there has been considerable privatization in France, the French government still retains ownership positions in several of that country's key sectors.

The preceding discussion illustrates the precarious nature of categorizing the nations examined here into the dichotomous world suggested by Figure 1. In terms of ownership concentration, Canada appears more like France and Germany than the United States, or the United Kingdom, while Japan appears to share more in common with the Anglo-American systems than those of Germany, or France do. Similarly, although France and

Germany share high levels of ownership concentration, banks play markedly different roles in these two countries. Salient differences also exist between the United States and the United Kingdom. While the United Kingdom and United States share similar ownership concentration levels, direct share ownership by households is more than twice as prevalent in the United States and ownership by financial institutions is much more common in the United Kingdom.

Similarities and differences across and between cells of Figure 1 extend to the structure and composition of corporate Board of Directors (BOD). This is not surprising because the role of the Board of Directors flows in part from the structure of ownership. In Germany and France, the composition of the BOD reflects the institutions (e.g., other firms, banks, and government) that are the major shareholders. In addition, Germany requires large public corporations to adopt a two-tiered board. The executive board is comprised of managers, while the nonexecutive, supervisory board is elected, half by shareholders and half by employees. As such, the German system allows for a clear distinction between decision management and decision control (monitoring) functions.<sup>31</sup> In France, firms have the option of choosing a one- or two-tiered system, but the latter has been rarely used. Workers' representatives have the right to attend meetings, but do not vote. Thus,

while the basic unitary board structure typically used in France is more consistent with that found in the United States, Canada, or the United Kingdom, French boards share more in common with their German counterparts in that they typically represent a broader array of stakeholders than Anglo-American boards.

Despite their larger size,<sup>32</sup> Japanese boards share more in common with those found in the United States and the United Kingdom than those in place in France and Germany. In terms of their composition, BODs in the United States, the United Kingdom and Japan are typically comprised of executives (managers) of the firm itself as well as a smaller number of outside directors who are commonly selected by management. As such, the ability of boards in these countries to effectively monitor management is highly questionable. As a consequence of the high levels of ownership concentration found in Canada, Canadian boards tend to have significant representation from majority shareholders. However, the Canadian model is very different from that of France and Germany insofar as stakeholders (i.e., banks, employees, and quite typically minority shareholders) are not represented on corporate boards.

The role of financial institutions as suppliers of capital and corporate governance players differs widely across countries. In this regard, Germany and Japan are similar in that banks are major shareholders and creditors. The importance of banks in these countries is also manifested in the way firms are financed. An examination of the ratio of total market capitalization of equities as a percentage of national GDP is dramatically illustrative in this regard. The fact that the value of equities exceeds national GDP in the United States (114 percent) and the United Kingdom (142 percent) and approximates GDP in Canada (86 percent) suggests the importance of equity markets and financing in these countries. In contrast, the relatively low ratios of market capitalization to GDP in Japan (66 percent), France (49 percent), and particularly Germany (28 percent) reflects the important role that banks and other financial intermediaries play in these countries. Thus, external equity markets are more important in the United Kingdom, the United States, and Canada while financial intermediaries play a more significant role as suppliers of capital in Japan, France, and Germany.

The relatively heavy reliance on equity finance and stock markets in the United Kingdom, the United States, and Canada is accompanied by stricter standards of corporate disclosure than that observed in Japan, France, and Germany. This is not surprising. Equity markets cannot function efficiently unless shareholders have access to the information necessary to assess managerial performance.

Shareholder and creditor rights are essential for effective corporate governance, and for the effective functioning of capital markets. A recent set of studies<sup>33</sup> has measured the extent to which the rights of shareholders and creditors are both legally protected and are exercisable, thus offering another basis for examining the significance and relative power of suppliers of debt and equity capital across the countries examined here. As Table III indicates, there is considerable variation in these measures among countries, with important differences found both within and across the cells of Figure 1.

As might be expected in the "bank-oriented"<sup>34</sup> systems of Japan and Germany where financial institutions play a central role in the governance of firms, creditor rights are better protected than in France, Canada, and the United States where banks play a more limited role as suppliers of capital. In Canada and the United States where equity financing is relatively more important, one finds high levels of protection for shareholders, but relatively weak protection for creditors. In contrast, the United Kingdom context provides high levels of legal rights for both shareholders and creditors. The fact that UK banks enjoy a high level of protection as a creditor despite their limited role as equity owners is another feature of the UK governance system that distinguishes it from that of the United States. Although Germany provides high levels of creditor rights, it offers relatively weak protection for equity holders. In contrast, Japan, which is also often considered a bank-oriented system, provides moderately high protection for equity holders in addition to the high legal safeguards it affords creditors.

Thus, in terms of the rights national systems afford equity holders and creditors, the United Kingdom and Japan more closely resemble each other than either resemble their "cell-mates" in Figure 1. Japan and espe-

cially the United Kingdom have evolved systems that provide a better balance between creditor and shareholder rights. In contrast the U.S. and German systems appear to favour either shareholder or creditor at the expense of the other. The balanced nature of the U.K. and Japanese systems indicate that there is not necessarily a trade-off between the legal rights and powers afforded shareholders and creditors; viable governance systems do exist where both shareholder and creditor enjoy high levels of legal protection. The fact that a G-7 country such as France scored poorly in terms of both the legal rights afforded shareholders and creditors is intriguing and may reflect the important role of the French state in that country's governance system.

The threat of a corporate takeover can be a powerful constraint on managerial behavior since top managers are likely to lose their jobs subsequent to a merger. The extent to which the takeover constraint is operative is a function of both public policy as well as the degree to which ownership structures permit hostile takeovers. Legislation is on the books in most countries that permit authorities to review and prohibit mergers. However, the most important differences in the operation of the market for corporate control emerge not from public policy differences, but from differences in corporate ownership and control.

Low levels of equity cross-ownership among firms, high ownership dispersion, robust equity markets, and rigorous disclosure laws have resulted in very active markets for corporate control in the United States and the United Kingdom. On the other hand, extensive intercorporate holdings in Japan, Germany, and France make hostile takeovers quite difficult. In particular, the historic reluctance of Japanese companies to sell their equity stakes in affiliated companies, or to engage in unsolicited merger activity has resulted in a particularly muted market for corporate control in that country.<sup>35</sup> Lax corporate disclosure in France, Germany, and Japan undoubtedly also has a dampening effect on the market for corporate control in these countries. The high levels of ownership concentration characteristic of German, French, and Ca-

nadian firms make unsolicited takeovers rare occurrences in these countries.

Executive compensation comprises both salaries and incentive packages such as stock options or profit-based bonuses.<sup>36</sup> In terms of both total compensation and the ratio of incentive compensation total compensation, the United States is an outlier relative to the other countries examined here (Table III). U.S. executives are both better paid and have a significantly greater incentive component in their remuneration package than their counterparts in any of the other countries examined here. Executive compensation in the United Kingdom more closely resembles that found in Germany and France where the interests of labor and concentrated ownership on corporate boards undoubtedly play a role in limiting levels of executive compensation.

In summary, an examination of the various institutional arrangements that define national systems of corporate governance as described in Table III clearly indicates that significant differences exist in the governance approaches of countries that may superficially appear to be similar. While it is true that the United Kingdom and the United States are both characterized by high levels of ownership dispersion, efficient equity markets, and robust markets for corporate control, they differ widely along other important governance dimensions such as the identity of share ownership, the extent to which creditor rights are protected and executive compensation practices. The additional observation that Canada has ownership concentration levels over 2.5 times greater than those found in either the United States or the United Kingdom illustrates quite clearly that there is no single "Anglo-Saxon" governance model. Even more striking distinctions exist among the governance systems of Germany, France, and Japan, making it quite obvious that there is also no single "stakeholder" model. These differences indicate that simple attempts to divide the world into two corporate governance camps are too general: there are many national systems of corporate governance.

### Some Empirical Evidence

We have undertaken two empirical studies that tend to confirm the idea that the simple

dichotomy between the Anglo-American and Continental European-Japanese models is too general.<sup>37</sup> Our approach was to examine the relationship between ownership concentration and firm performance in the six countries listed in Table III. As noted above, agency theory predicts a positive correlation between ownership concentration and firm performance since large shareholders have both the incentive and capacity to ensure that managers adopt practices consistent with profit maximization.

In fact, a large number of empirical studies have tested this hypothesis. Surveys of these studies<sup>38</sup> conclude that most of them tend to find that concentrated ownership does improve firm performance. Unfortunately, the vast majority of these studies examined only U.S. firms and the existing evidence on the relationship between ownership concentration and firm performance outside of the United States context is very limited. Our studies were designed to address this gap in the scientific literature by testing this relationship for a broader range of countries using a common data set. In doing so, our studies also provided some evidence concerning the relative performance characteristics of the six national systems of corporate governance examined.

The positive relationship between ownership concentration and firm performance predicted by agency theory rests on two important assumptions. First, exercisable managerial discretion exists, and second, the primary goal of shareholders is profit maximization.

The first point accounts for the fact that ownership concentration is but one determinant of managerial discretion and that there are other constraints that may be operative. The degree to which these constraints are binding shapes the ownership concentration-performance relationship. If any one or more of these constraints effectively checks managerial discretion, then ownership concentration is irrelevant, and one should find no relationship between ownership concentration and profitability. In other words, concentrated ownership serves as the constraint of last resort and is operative only in cases where other internal and external constraints fail to check managerial cost augmentation, or self-interested strategizing.

The second condition reflects the fact that the investment objectives of shareholders may

be more highly varied and heterogeneous than is often assumed. For an "arm's length" shareholder whose sole tie to a corporation is an equity investment, profit maximization is a reasonable assumption. On the other hand, some shareholders have multiple ties to a corporation and may be a creditor, customer, supplier, and/or business partner in addition to being an equity investor. Under such circumstances, the economic significance of their equity ownership may be an order of magnitude less significant than their other association(s).

As a practical example, consider the fact that the stakes of Japanese and German financial institutions as creditors typically dwarf their less economically significant equity ties.<sup>39</sup> Accordingly, as the primary relationship of these equity holders is as creditor, not a shareholder, they can be expected to favor income stability objectives (to preserve and enhance the value of their loan portfolio) and growth objectives (in order to expand their loan portfolio) rather than the profit maximization goals of arm's length shareholders. Similarly, when shareholders are also suppliers and customers, they can be expected to be more interested in securing ongoing trade relationships rather than profit maximization—especially since measures to enhance profitability may often come at the expense of suppliers and customers. As a final illustration that shareholder objectives are more varied and heterogeneous than is frequently assumed, it is almost axiomatic that government share ownership is motivated by objectives that differ substantially from private sector investors.

As documented in Table III, the ownership structure of French, German, and Japanese corporations are comprised largely of shareholders who have other non-equity ties with the firm. As such, shareholders in these countries can be expected to have heterogeneous investment objectives. Accordingly, we have hypothesized there should be no relationship between ownership concentration and firm performance in these three countries. We also hypothesized no ownership-performance relationship in Canada because of the presence of both strong external and internal constraints on managerial discretion in that national context. In contrast, we hypothesized a positive ownership-performance relationship in the United States and the United Kingdom because of the apparent absence of effective

internal constraints on managerial discretion and because the interests of arm's length Anglo-American shareholders are best served by profit maximization.

In summary, like many other researchers,<sup>40</sup> our two studies were based on the theoretical premise that there exist two essential varieties of national governance systems: the market-oriented Anglo-American model and the network-oriented model of continental Europe and Japan. In doing so, and guided by considerations related to the nature of managerial constraints and the goals of shareholders described above, we generated hypotheses that predicted a positive relationship between ownership concentration and performance in market-oriented systems, but no relationship in network-oriented systems.

Our results deviated significantly from our expectations and offered a strong indication that the micro-processes which underlie national systems of corporate governance are too complex to be captured by a simple market/network dichotomy. As expected, we found no relationship between ownership and performance in Canada and in the network-oriented systems of France and Japan, but we also observed no such relationship in the United Kingdom—one half of the presumed "Anglo-American" market-oriented system. As predicted, we found a positive ownership-performance relationship in the United States (the other market-oriented Anglo-American system), but contrary to our expectations we found an even stronger positive relationship in Germany an archetypal network-oriented system.

Thus, in terms of what is certainly the most studied theoretical relationship in corporate governance, the link between ownership concentration and firm performance, we found strong evidence *inconsistent* with the widespread belief that there exist two distinct systems. In other words, the market/network dichotomy is inconsistent with empirical observation regarding what most experts consider to be the most critical relationship in corporate governance.<sup>41</sup>

### Conclusion

The material structural differences documented in Table III, as well as the empirical tests of the ownership concentration-performance relationship described above indicate that national systems of governance remain highly distinctive in

terms of both their structural features and the effects these features have on fundamental governance relationships. Such a diversity of corporate governance systems across successful national economies has a number of implications.

First, it indicates that even among the elite group of economies examined here, the convergence of national governance systems is significantly less evident than is commonly believed. In fact, the evidence reported here strongly suggests that even the widespread assumption that the world's most developed economies have converged on two distinct models of governance must be approached with extreme caution.

Set against the backdrop of the extensive differences documented above, recent developments such as the unwinding of some equity cross-holdings in Japan, the 1999 repeal in the United States of the Glass-Steagall Act (which severely circumscribed the ability of U.S. banks to hold and exercise equity stakes) and the Vodafone-AirTouch hostile takeover of Mannesmann, represent, at best, quite modest steps towards convergence.

Second, it is clear that in today's increasingly integrated global economy, an effective system of corporate governance is one that promotes economic development and engenders internationally competitive firms. On the other hand, a viable system of corporate governance must also reflect a society's basic values concerning the rights and responsibilities of economic actors. As such, successful national systems of corporate governance are those that have created viable and enduring solutions that reflect both global forces for convergence and national forces for local variation. While it is clear that many countries around the world have yet to develop effective governance systems, our finding that rather distinct systems have evolved and continue to be employed across successful and affluent economies suggests that the need for global convergence on many dimensions of corporate governance may be overstated.

Lastly, while the notion of best practice is powerfully seductive, it is also potentially misleading and possibly detrimental when it comes to systems of corporate governance. In fact, scholars of industrial organization and strategic management have long understood that what constitutes best practice is highly contingent upon both function and context. Since

what constitutes best practice can be context specific, there is likely no one best governance system, but rather a variety of systems with relative advantages and disadvantages and these may vary across both countries and industries. According to Michael Porter,<sup>42</sup>

Ownership structures, capital market conditions, and the nature of corporate governance have...broad influences on national

advantage...Nation's will succeed in industries where the goals of owners and managers match the needs of the industry.

Viewed in such a manner, the observed heterogeneity of national governance systems we describe above is representative of both an efficient specialization of function and a robust diversity of economic activity which would be lost if radical harmonization were to take place.

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**ERIC R. GEDAJLOVIC** is Associate Professor of International Business in the Strategy and Business Environment Department of the Rotterdam School of Management. His research relating to the comparative analysis of business, financial, and governance systems has been published in leading international management journals.

**DANIEL M. SHAPIRO** is Professor of Business and Economic Policy in the Faculty of Business Administration, Simon Fraser University. His research in the areas of corporate performance, ownership, industrial structure, and public policy has appeared in a variety of management and economics journals. He has served as a consultant to a variety of Canadian and international public and private institutions.

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