A Comparative Theory of Corporate Governance

Franklin Allen and Douglas Gale

Comparative Corporate Governance:
Changing Profiles of National Diversity

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Two views of corporate governance:

- Anglo-Saxon capitalism: Only the interests of shareholders matter

- Stakeholder capitalism: The interests of employees, customers and others matter as well as those of shareholders

Anglo-Saxon Capitalism

- Based on Adam Smith's "Invisible Hand"
- All agents should pursue their own interest
  - Individuals should maximize their utility
  - Firms should create wealth for shareholders

Anglo-Saxon Capitalism (cont)

- Widely analyzed and understood

- Modern version based on Arrow-Debreu model requires strong assumptions
  - Perfect and complete markets
  - Symmetric information
  - Perfect competition

Stakeholder Capitalism

- There is evidence that companies in Japan, Germany and France behave very differently from those in the US and UK

Figure 1: Whose Company Is It?

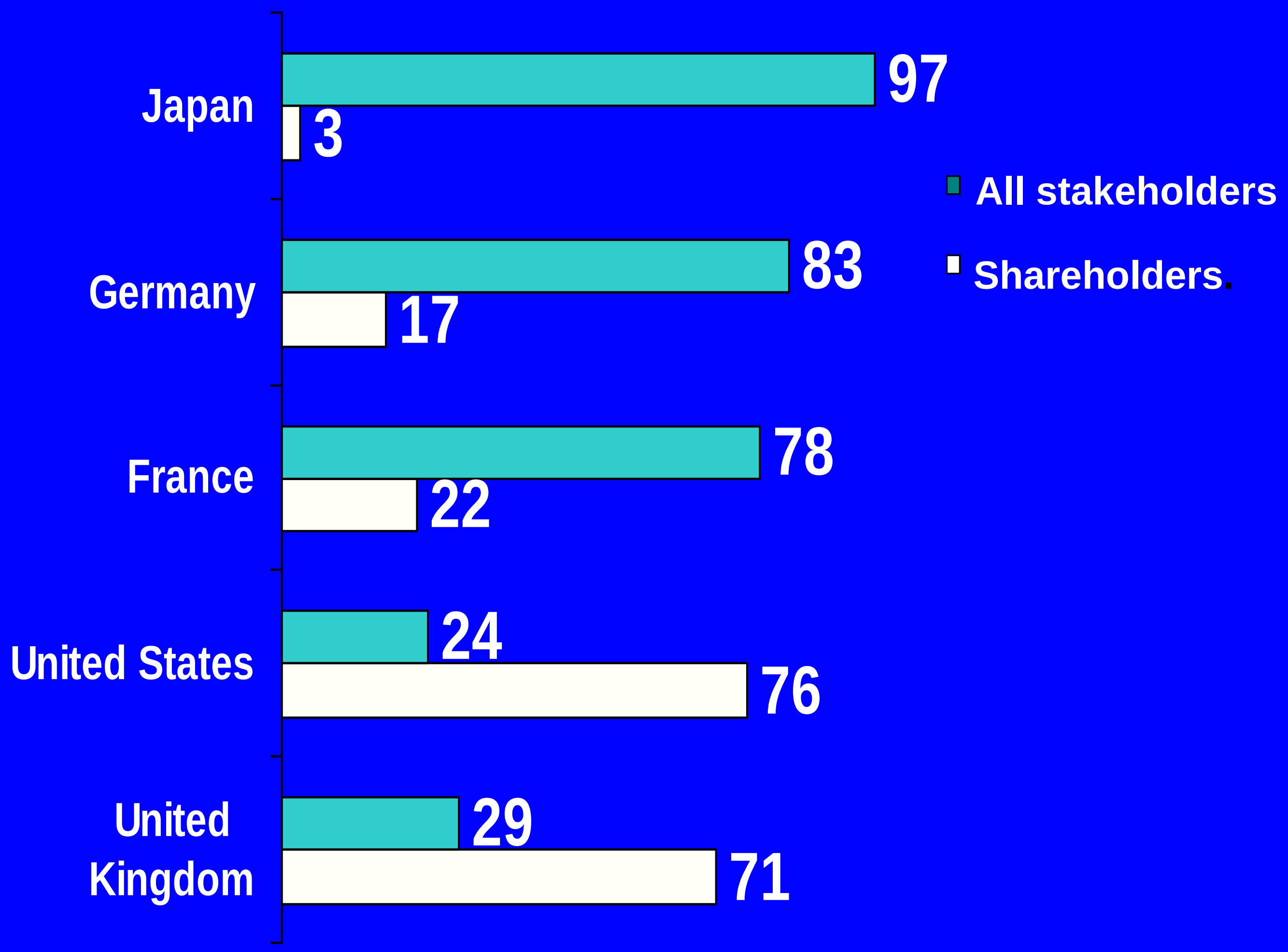
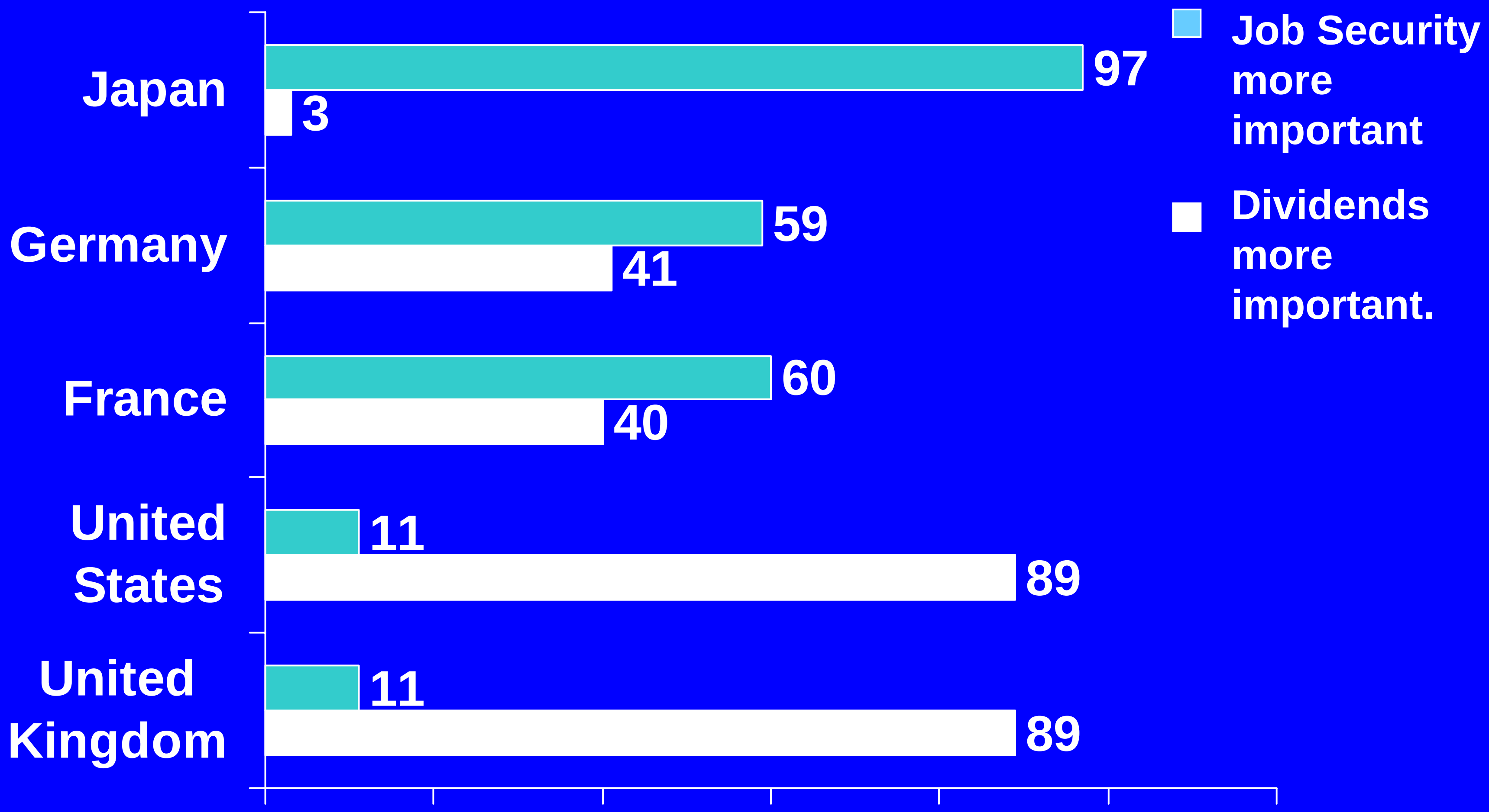


Figure 2: Job Security or Dividends?



Stakeholder Capitalism (cont)

- Stakeholder capitalism has not been analyzed nearly as much as Anglo-Saxon capitalism

- Aoki (1990; Journal of Economic Literature) contains an excellent overview of the work he and others have done on comparing Japanese (J-mode) firms and US (H-mode) firms

Purpose of this paper

- To show that in an imperfect world where the assumptions of the Arrow-Debreu model are not satisfied stakeholder capitalism can do better than Anglo-Saxon capitalism

- J-mode firms are based on consensus and cooperation while H-mode firms have a single manager tell everybody what to do

A Cooperative Theory of the Firm

- **H-mode:** Problem with Anglo-Saxon system where the manager in complete control obtains rents:
  - The manager has limited tenure and so takes a short view
- **J-mode:** Large corporations are run by groups of managers that may self-perpetuate
  - By having overlapping generations of managers that must reach consensus and cooperate it is possible to have a corporation that takes a long view

The J-mode model

- At any time one old manager and one new manager are required to run the firm
- The managers must coordinate to
  - Pursue the shareholders' interests in which case they receive r
  - Seek rents for themselves in which case they receive R where

$$R > r > 0$$

- Unless they both cooperate and do the same thing they receive a very low payoff

- If shareholders observe managers shirking they can replace them immediately

- If they both pursue the shareholders' interest
  - Payoff to young managers is $r/2+r/2 = r$
  - Payoff to old managers is $r/2$
- If they both seek rents
  - Payoff to young managers is $R/2 + 0 = R/2$
  - Payoff to old managers is $R/2$
- Old managers always better off seeking rents since $r/2 < R/2$
- Viability Condition: Young managers will prefer pursuing the shareholders' interests and this will be the equilibrium if

$$r \geq R/2$$

The H-mode model

- A single representative manager runs the firm
- When he is old he will choose to rent seek since

$$R > r$$

A comparison

- The J-mode allows the efficient allocation to be implemented provided

$$r \geq R/2$$

- The H-mode does not allow the efficient allocation to be implemented

Extensions

- The model can be extended to allow for
  - N-period lives
  - Different incomes and rents
  - Other stakeholders

No management dismissal

- Results do not depend on assumption of immediate dismissal if shirking
- Provided firm goes “downhill” when there is no cooperation incentives for effort can be provided
- Firms must be able to convince young employees they have a viable future otherwise they will not attract them

Employment

- An important characteristic of the Japanese system is lifetime employment and an inflexible labor market

- Consider the simple model from above and suppose the probability of continued employment even if shareholders interests are pursued is π

- Viability condition for cooperation is now

$$r/2 + \pi r/2 + (1-\pi)0 \geq R/2 + 0$$

or

$$r \geq R/(1 + \pi)$$

- This is more likely to be satisfied the higher is π

- Lifetime employment is desirable in this model and when there are N periods

- The utility of being unemployed is 0 in these models
- The lower this is the more likely the viability condition is to be satisfied
- Inflexible labor markets can provide incentives for greater cooperation

Income distribution

- So far the distribution of income between shareholders and employees is given
- What happens if there is a bad shock?
- To maintain cooperation the viability condition must remain satisfied

- Suppose the workers are paid a gross wage of R and have disutility of η from effort so

$$r = R - \eta$$

- The viability condition becomes

$$R/2 \geq \eta$$

- In order to keep this satisfied it may be necessary to keep wages high even if this means cutting dividends

Concluding remarks

- Anglo-Saxon capitalism is only one form of capitalism – there are potentially many others

- Stakeholder capitalism can be superior if there are imperfections

Concluding remarks (cont)

- Model is very simple and many extensions are possible
  - Including compensation of employees and shareholders
  - Allow for general equilibrium
  - Allow for competition between firms
- Stakeholder capitalism needs to be much more extensively studied