A Comparative Theory of Corporate Governance

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Corporate Governance in Perspective:
Diversity or Convergence
January 10, 2003
Tokyo, Japan

US View of Corporate Governance

- Firms sole objective should be to create wealth for shareholders
- Corporations in Japan and many other countries do not do this so the conclusion is they have poor corporate governance

Standard Corporate Governance Mechanisms

- Effective Board of Directors with sufficient outsiders
- Management compensation aligned with shareholders’ interests (e.g. stock options)
- Market for corporate control (hostile takeovers)
- Intervention by banks

Corporate Governance in Japan

- By and large these mechanisms are not applicable in Japan

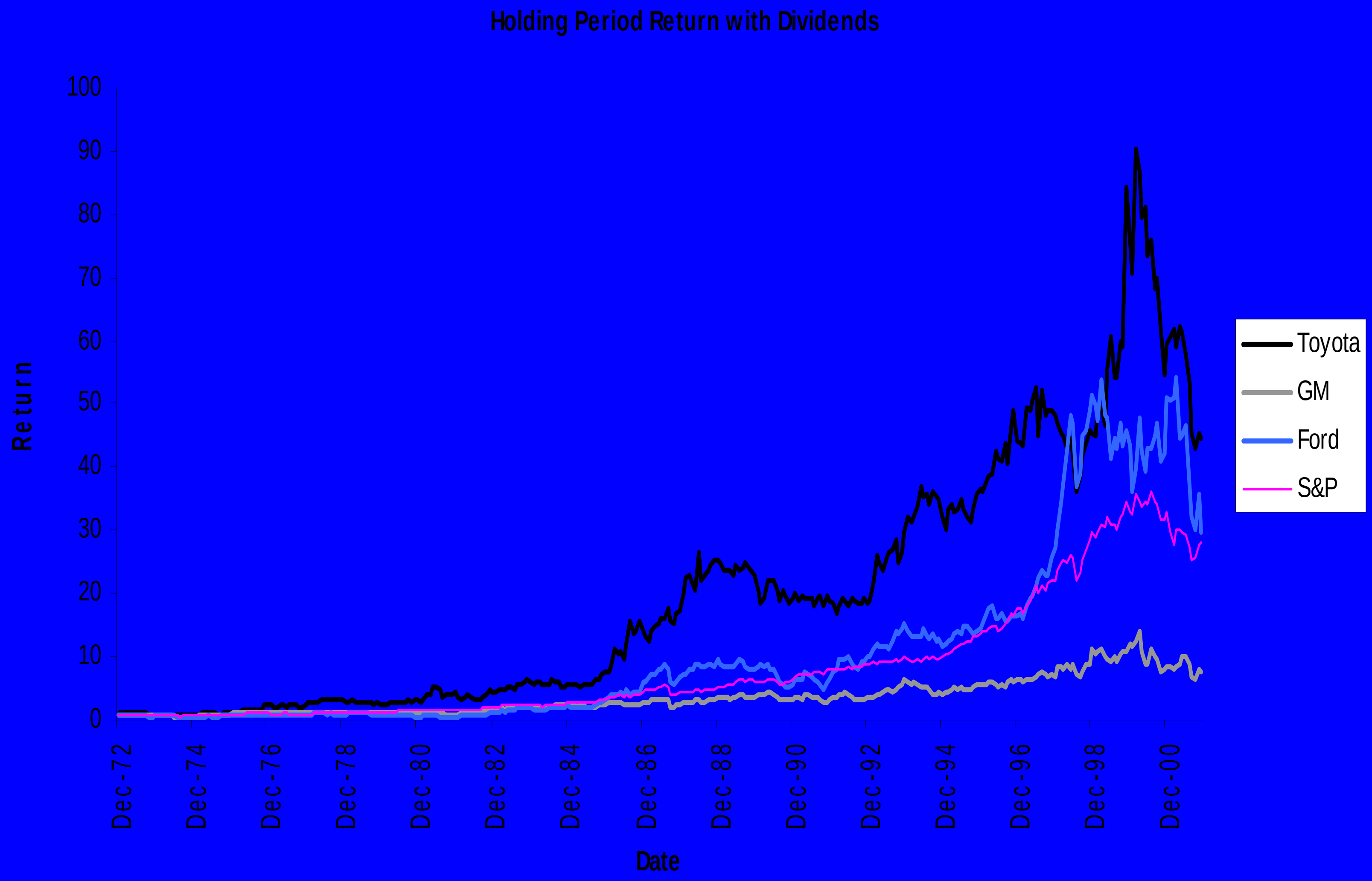
- E.g. Toyota
  - Board of directors: 60 people with 1 outsider
  - Managers paid much less than in the US and traditionally have not had stock options
  - No hostile takeovers in Japan
  - ¥3.5-¥4.0 Trillion cash holdings so banks have little influence

Corporate Governance in Japan (cont)

- According to standard view Toyota should be a poorly run firm and should have produced low returns for shareholders

Corporate Governance in Japan (cont)

- BUT IT IS VERY SUCCESSFUL!
- In the long run it has performed better for shareholders than Ford, GM and even the S&P 500


Holding Period Return with Dividends
Return
100
90
80
70
60
50
40
30
20
10
0
Dec-72
Dec-74
Dec-76
Dec-78
Dec-80
Dec-82
Dec-84
Dec-86
Dec-88
Dec-90
Dec-92
Dec-94
Dec-96
Dec-98
Dec-00
Date
Toyota
GM
Ford
S&P

Stakeholder Capitalism

- Why is the standard US view so wrong here?

- It ignores alternative forms of capitalism such as stakeholder capitalism

- Stakeholder capitalism is where companies pursue the interests of many stakeholders such as employees as well as shareholders

Figure 1: Whose Company Is It?

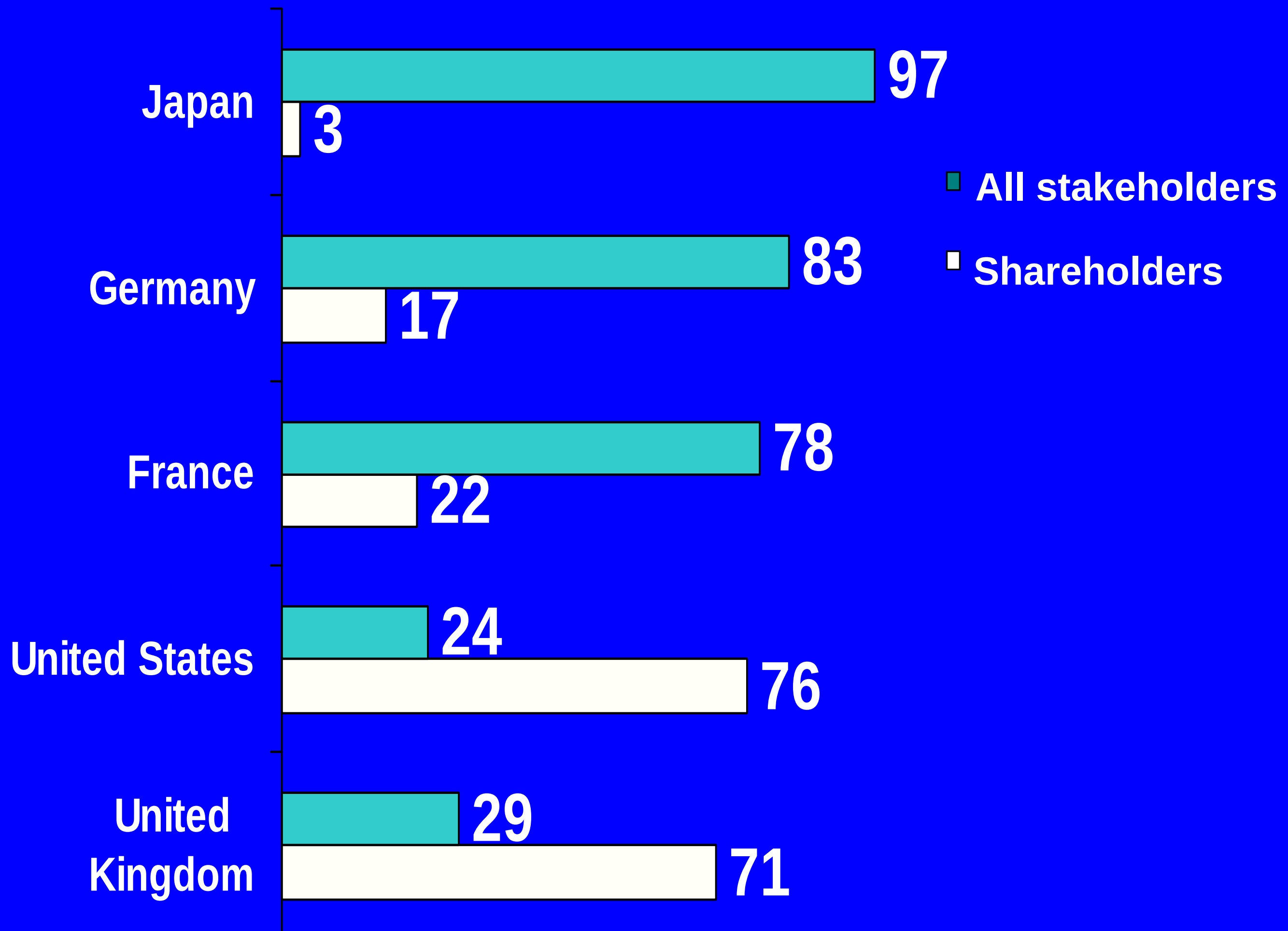
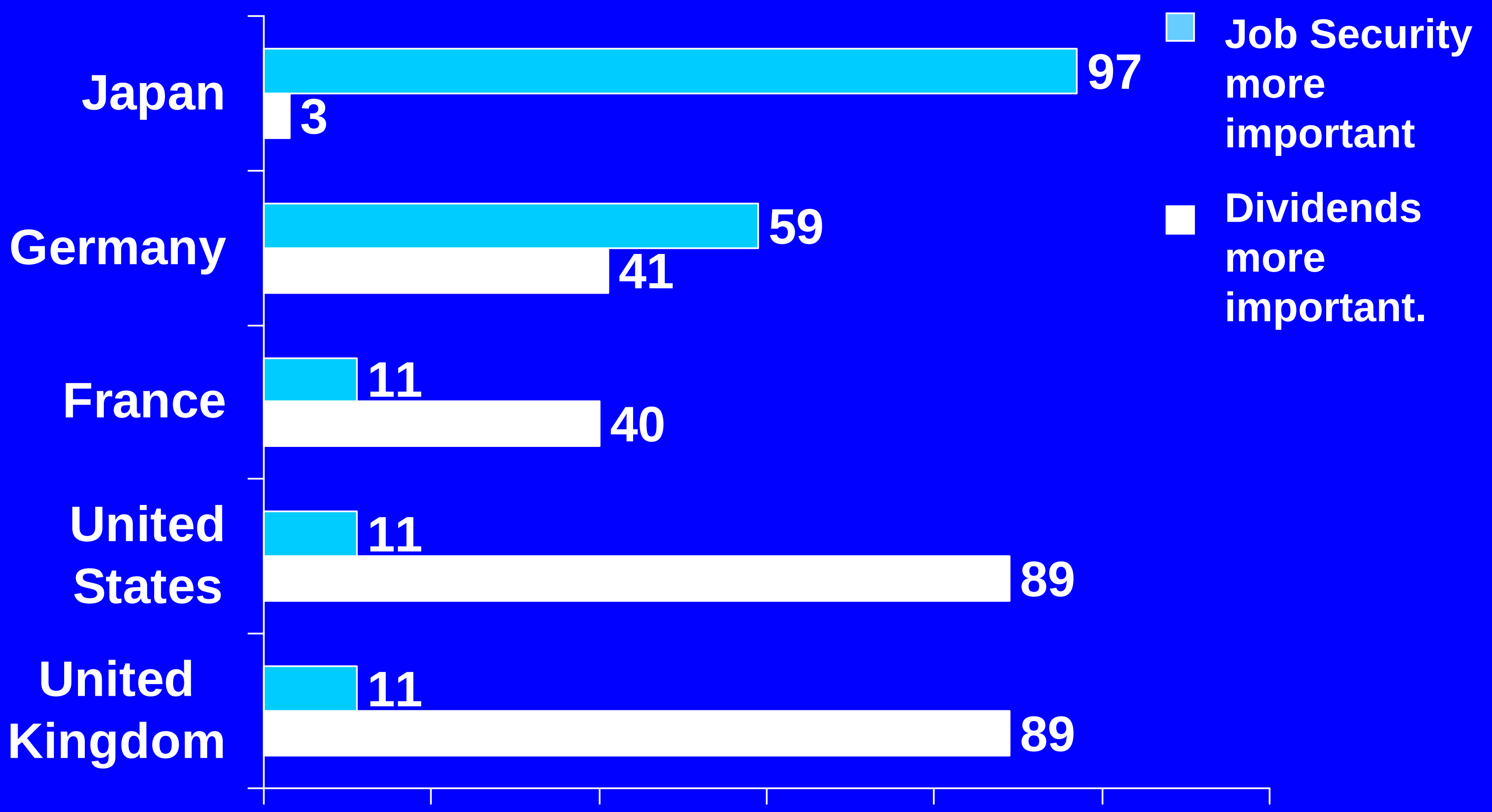


Figure 2: Job Security or Dividends?



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

Results in our paper

- In an imperfect world stakeholder capitalism can do better than Anglo-Saxon capitalism

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

A comparison

- The J-mode allows the efficient allocation to be implemented because the effect of requiring consensus and cooperation is that decisions are made for the long run

- The H-mode does not allow the efficient allocation to be implemented – top managers have too much power and abuse it

Employment

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

- With Anglo-Saxon capitalism these are undesirable but with stakeholder capitalism they are an advantage and make consensus easier to achieve

Income distribution

- What happens if there is a bad shock to a J-mode firm?
- In order to maintain cooperation it may be necessary to keep wages and employment high even if this means cutting returns to shareholders such as dividends
- This is the opposite of what happens in an H-mode firm

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
- Stakeholder capitalism needs to be much more extensively studied

Concluding remarks (cont)

- Important not to attribute the effects of bubble collapse to corporate governance