

Comment on Colin Mayer "Evolution of Ownership: A three Country Comparison of The UK, Germany and Japan"

September 13, 2005

This is a part or the summary part of an ambitious study conducted by the authors recently in order to clarify the long-run evolution of investor protection of the three countries. In particular, the authors tries to analyze what factor is responsive for the development of active equity markets with the participation of a large number of investors. The authors examined two factors; government regulations and relationship and trust among investors and directors. The main result they obtained is that while regulation is not a necessary condition for the emergence of active securities markets, trust among investors is closely related to the development of active security markets. The result is reasonable in view of the experience of Japan as far as I know, and I enjoyed the paper very much. Before giving a comment on the paper, let me touch upon the authors' finding that the development of active equity markets during the first half of the 20th century relied on informal relations of trust based on regional community. I would like to point out that almost exactly the same thing happened in Japan during the period before WWI. New firms were established as a joint capital companies by rich merchants and landlords, who know each other quite closely because of regional ties or because of engagement in related occupations. For example, many local manufacturing companies were established by groups of rich people in the same region and cotton spinning companies were established by groups of textile merchants and apparel traders. Because these people were tied with each other by strong trust and reputation effects, there was no room for serious agency costs among managers and outside and inside shareholders.

In Japan, it was only after WWI, when middle class has merged and began to invest their savings to these companies. Moral hazards by managers and controlling shareholders have become a serious social problem thereafter. In this regard, it is interesting to note that the moral hazard was overcome not by strengthening of investor right but by the increasing share of corporate ownership. Large corporations with reputation came to play the role of monitoring firms, and there were no significant legislation regarding investor right. The difference between the UK and Japan seems to be an interesting topic examined in the future research.

Having said this, let me give my comment that is concerned with the role of regulation in this paper. In analyzing how the government regulation on the investor protection affects the development of active equity markets, the authors resort to the hypothesis set forth in a series of papers by La Porta, Lopez-de-Silanes, Shleifer and Vishny (LLSV), which examined the degree of investment protection in the light of the origins of national legal system. LLSV have shown that countries with legal origin of common law such as UK and USA has strong protection of investors and countries of legal origin of civil law has weak protection of investors and the use of external financing is more pronounced for countries with civil law traditions. Moreover, they argue that countries with weak investor protection are characterized by concentration of ownership. These propositions are derived in an examination of cross-country regression using the sample of some forty countries.

Colin Mayer and others apply the last proposition of LLSV, namely a proposition regarding the concentration of ownership and investor right, to the historical evolution of investor right of the three countries, and try to examine whether the introduction of regulation on investor right is responsive for the emergence of active securities markets through encouraging the participation of minority investors. It must be noted that the conjecture of the authors is based on the assumption that the regulation on the minority abuse or legislation on investor right is endogenous to the system. In other words, they assume that regulations on investor right could be introduced by the intention of the governments irrespective of the development level of equity markets. While introduction of regulations in an economy is exogenous in many cases, some regulations including those regarding investor right seem to be largely endogenous. This is because necessity of regulation is recognized only when number of minority investor has increased and exploitation of them has come to exert some influences on the economy. Quite often, there would be conflicts of interests among those who benefit from the regulation such as minority shareholders and those who would lose from the regulation such as controlling shareholders and corporate managers, and the political process of legislation would involve active rivalry among interest groups. In other words regulation of this kind is introduced only when equity markets have already become large and active, and when abuse of minority shareholders has become a serious social issue. Therefore, it is difficult to conceive of a situation where regulations on minority abuse are introduced before the development of equity markets reached a certain stage.

In the regression given in table 8 of the paper by LLSV (1998 JF), the effect of the development of equity market is controlled by GNP. In other words, what LLSV intend to say is that, given the degree of development of equity markets or the degree of mobilization of small savers, a country with weak investor right has a higher ownership concentration than a country with stronger investor right.

Incidentally, some of regulations are not exogenous when it is propelled by strong influence of economic thought such as populism and developmentalism. Introduction of investor protection in the US during the 1930s was strongly influenced by the spread of populism in the politics, and the introduction of the rationing system of bonds market in postwar Japan was brought about under the strong influence of developmentalism entertained by bureaucrats.

It follows that whenever equity market is underdeveloped or at a nascent stage, one cannot expect any regulations regarding investor right. The authors seems to have been guided by a wrong conjecture without paying due attention to the endogeniety issue of policy formation. However, this drawback is easily corrected by a slight revision of presentation, and I want to emphasize that despite this point the aim of the paper is worth pursuing and the result obtained so far is highly valuable.