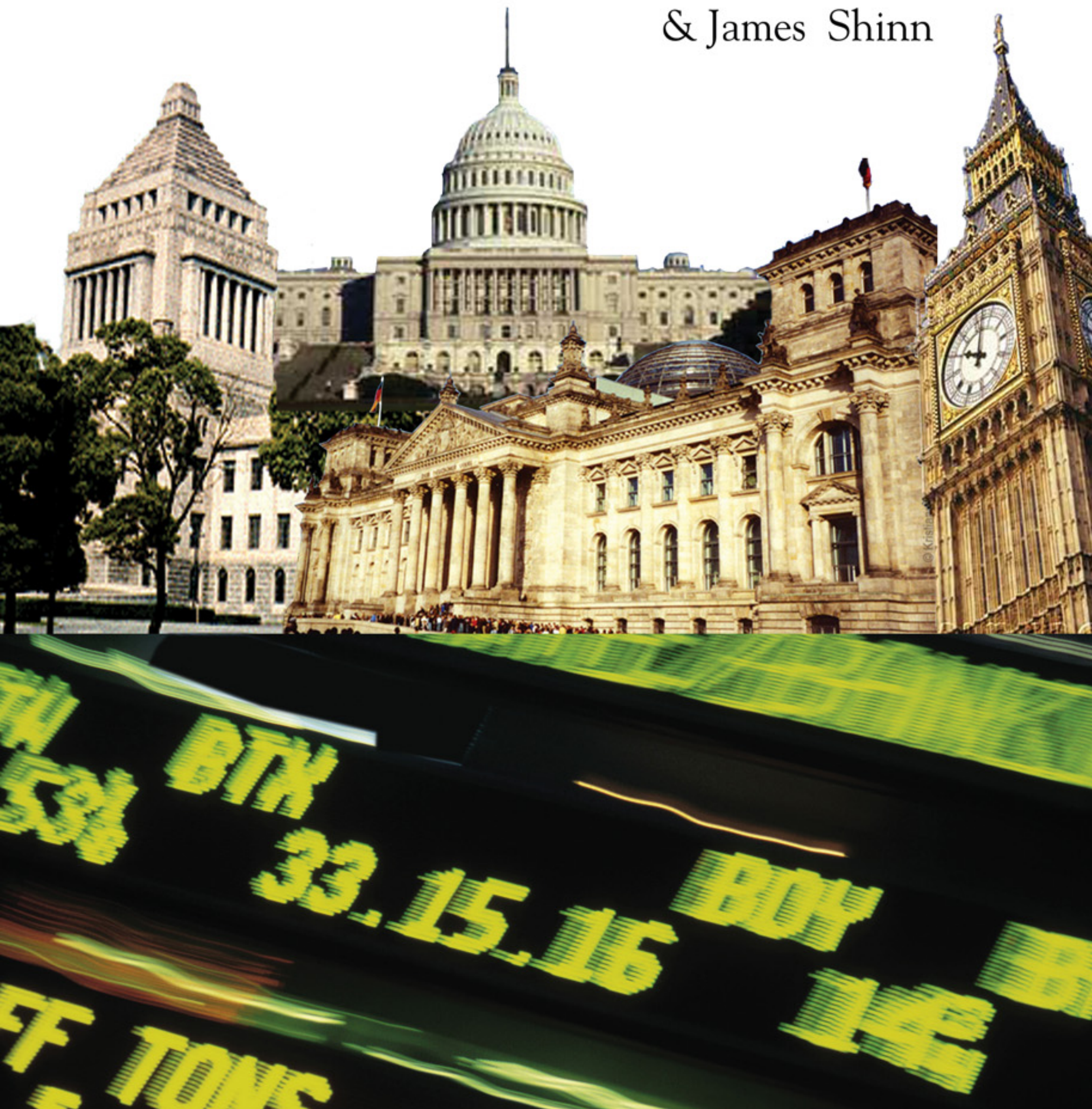
Political Power & Corporate Control

THE NEW GLOBAL POLITICS OF CORPORATE GOVERNANCE

Peter A. Gourevitch
& James Shinn



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PETER ALEXIS GOUREVITCH AND JAMES J. SHINN

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ABBREVIATIONS

A&P:	Atlantic and Pacific Company
ABN AMRO:	Large banking firm headquartered in the Netherlands.
ABP:	Algemeen Burgerlijk Pensioenfonds (Netherlands)
ABRASCA:	Associação Brasileira das Companhias Abertas
ACWI:	All Country World Index
ADRs:	American depositary receipts
AEGON Nederland:	Dutch financial institution
AFG:	Association Française de la Gestion Financière
AFL:	American Federation of Labor
AFL-CIO:	American Federation of Labor-Congress of Industrial Organizations
AFP:	Administradora de Fondos de Pensiones
AGF-Paribas:	Assurances Générales de France and Paribas
AGM:	Annual general meetings
AKZO Nobel:	Large multinational firm headquartered in the Netherlands, dealing in chemicals, coatings, and healthcare products
AOW:	Algemene Oudermans Wet (Netherlands)
ARRCO:	Association pour le Régime de Retraite complémentaire de Salariés (France)
ASC:	Accounting Society of China
ASEAN:	Association of Southeast Asian Nations
AT:	Austria
ATP:	Allmänna Tilläggspension (Sweden)
AU:	Australia
BADC:	Kigyô Kaikei Shingikai (Business Accounting Discussion Council) (Japan)
BASF:	Badische Anilin und Soda-Fabrik AG, a large chemicals multinational headquartered in Germany
BDI:	Bundesverband der Deutscher Industrie (Germany)
BE:	Belgium
BIS:	Bank for International Settlements
CA:	Canada
CAC-40:	Compagnie des Agents de Change, a broad-based stock index for the Paris Bourse, since 1998 part of SBEF, Société de Bourse Francaise (SBEF)
CalPERS:	California Public Employees' Retirement System
CAS:	Chinese accounting standards
CCP:	Chinese Communist Party
CDU:	Christian Democratic Party (Germany)

CEO: Chief executive officer
CEP: Capitalist Economic Policies
CES: Creative Electronic Systems (Germany)
CH: Switzerland
CI: Coordination Index
CICPA: China Institute of Certified Public Accountants
CII: Council of Institutional Investors (U.S.)
CIO: Congress of Industrial Organizations (U.S.)
CL: Chile
CME: Coordinated Market Economies
CNAVTS: Caisse Nationale d'Assurance Vieillesse des Travailleurs Salariés (National Fund for Salaried Workers' Old Age Insurance) (France)
CNC: Conseil National de la Comptabilité (France)
CPA: Certified public accountant
CPF: Central Provident Fund (Singapore)
CRC: Comité de la Reglementation Comptable (France)
CSRC: China Securities Regulatory Commission
CSX: CSX Corporation, a large freight transportation company (U.S.)
DASC: Disclosure and Accounting Standards Committee
DB: Defined benefits
DE: Germany
DK: Denmark
DoC: Degrees of Coordination
DPI: Database of Political Indicators
DRSC: Deutscher Rechnungslegungs Standards Committee (Germany)
DSM: Large multinational chemical manufacturer, based in the Netherlands
DSR: Deutscher Standardisierungrat (Germany)
EPF: Employees Provident Fund (Kumpulan Wang Simpanan Pekerja) (Malaysia)
ERISA: Employee Retirement Income Security Act
ESOPs: Employee Stock Option Plans
EU: European Union
EVA: Economic value added
FASB: Financial Accounting Standards Board
FDI: Foreign direct investment
FDP: Free Democratic Party (Germany)
FESE: Federation of European Stock Exchanges
FI: Finland
FIBV: Federation Internationale des Bourses de Valeurs (International Federation of Stock Values)
FKI: Federation of Korean Industry

FPI: Foreign portfolio investment, distinct from FDI, foreign direct investment
FR: France
FSA: Financial Services Agency (Japan)
FSA: Financial Services Authority (United Kingdom)
FSC: Financial Supervisory Commission
GAAP: Generally accepted accounting principles (U.S.)
GB: United Kingdom
GCGF: Global Corporate Governance Forum
GDP: Gross domestic product
GLCs: Government-linked companies
GTE: General Telephone and Electronics
HGB: Handelsgesetzbuch (commercial code) (Germany)
HK: Hong Kong
IAS: International Accounting Standard
IASB: International Accounting Standards Board
IASC: International Accounting Standards Committee
IBM: International Business Machines
ICC: International Chamber of Commerce
ICPAS: Institute of CPAs of Singapore
IDC: International Data Corporation (U.S.)
IDR: International depository receipts
IE: Ireland
IFO: International financial organization
IFRS: International Financial Reporting Standards
IMF: International Monetary Fund
ING: Dutch Financial services firm. Originally Internationale Nederlanden Group, now officially ING Group.
IO: International organization
IPCOH: Index of political cohesion
IPD: Implicit pension debt
IPD: Integrated project development
IPO: Initial public offering
IRS: Internal Revenue Service (United States)
IT: Italy
JCGA: Japan Corporate Governance Association
JICPA: Japanese Institute of Certified Public Accountants
JP: Japan
KapAEG: Kapitalaufnahmeerleichterungsgesetz (the law on facilitating raising capital) (Germany)
KASB: Korean Accounting Standards Board, or Hanguk hoegye kisun wiwon
Keidanren: Keizaidantai-rengokai (Japan)
KEPCO: Korea Electric Power Company
KFAS: Korean Financial Accounting Standards

KLM: Royal Dutch Airlines (Netherlands)
KLSE: Kuala Lumpur Stock Exchange (Malaysia)
KonTraG: Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (the law on control and transparency of corporations)
KOSDAQ: Korea Association of Securities Dealers Automated Quotation
KPN: Netherlands telecommunications company
KSE: Korean Stock Exchange
LDP: Liberal Democratic Party (Japan)
LG: Lucky-Goldstar (Korea)
LLSV: La Porta, López-de-Silano, Shleifer, and Vishny
LME: Liberal market economy
LSE: London Stock Exchange
M&A: Mergers and acquisitions
MACPA: Malaysian Association of Certified Public Accountants
MASB: Malaysian Accounting Standards Board
MCA: Malaysian Chinese Association (Persutuan China Malaysia)
MGAAP: Malaysia's generally accepted accounting principles
MIA: Malaysian Institute of Accountants
MITI: Ministry of International Trade and Industry (Japan)
MOF: Ministry of Finance (Japan)
MOFE: Ministry of Finance and Economy (Japan)
MSCI: Morgan Stanley Capital International, Inc.
MSP: Minority shareholder protection
NASDAQ: National Association of Securities Dealers Automated Quotations
NBFI: Non-bank financial intermediaries
NCR: National Cash Register Corporation (U.S.)
NED: Non-executive director
NL: Netherlands
NLRB: National Labor Relations Board
NO: Norway
NRE Bill: loi sur les Nouvelles regulations economiques de 2001 (New Economic Regulations Bill of 2001, France)
NV: Naamloze Vennootschap (Netherlands)
NYSCRF: New York State Common Retirement Fund (U.S.)
NYSE: New York Stock Exchange (U.S.)
NZ: New Zealand
O: Owners
OECD: Organization for Economic Cooperation and Development
OLS: Ordinary least squares
OME: Organized market economy

PAP:	People's Action Party (Singapore)
PAYGO:	Pay-As-You-Go pension system
PBGC:	Pension Benefits Guarantee Corporation
PGGM:	Stichting Pensioenfonds voor de Gezondheid, Geestelijke en Maatschappelijke Belangen (Netherlands)
PRA:	Personal retirement account
PSA:	Port of Singapore Authority (Singapore)
QCL:	Quality of corporate law
R&D:	Research and development
RIETI:	Research Institute of Economy, Trade, and Industry (Japan)
SAF:	Svenska Arbetgivarforening (Sweden)
SCGOP:	Stichting Corporate Governance Onderzoek voor Pensioenfondsen (Netherlands)
SE:	Sweden
SEC:	Securities and Exchange Commission (United States)
SER:	Sociaal Economische Raad (Consultative tripartite Social and Economic Council)
SIB:	Securities and Investment Board (United Kingdom)
SIPO:	Share initial public offering, used in place of IPO
SK:	Sankyong (Korea)
SNCF:	Syndicat National des chemins de fers (the National Train Authority, France)
SOE:	State-owned enterprise
SPD:	Sozialedemokratische Partei Deutschland (German Social Democratic Party)
SSE:	Singapore Stock Exchange
SVS:	Superintendencia de Seguros y Valores (Chile)
TEFRA:	Tax Equity and Fiscal Responsibility Act of 1982
TIAA-CREF:	Teachers Insurance and Annuity Association-College Retirement Equities Fund
TLCs:	Temasek listed companies
TransPuG:	The Corporate Sector Transparency and Publicity Act
TVA:	Tennesee Valley Authority
UAP-BNP:	Unions des Assurances de Paris and Banque Nationale de Paris
UMNO:	United Malays National Organization (Pertubuhan Kebangsaan Melayu Bersatu)
US:	United States
US-GAAP:	U.S. generally accepted accounting principles
VoC:	Varieties of Capitalism
W:	Workers
WWI:	World War I
WWII:	World War II
WWTR:	Worldwide total remuneration

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PREFACE

THE LIMITED LIABILITY company is approaching its four hundredth birthday.[1] Its creation provided a powerful engine for economic growth by mobilizing capital and rewarding risk-taking. Economies with deep capital markets and healthy corporate structures grow faster than those with weak financial and corporate structures. At the same time, corporations are vulnerable to problems of accountability and responsibility. Recent scandals (Enron, Parmalat, Adelphia, Ahold, etc.) are repeats of events familiar to historians of the corporation.

Looking at corporate structures around the world would fascinate Darwin. There is no single form, but many. The United States has strict rules on insider trading, hostile takeovers, the composition of boards, the process of proxy voting; it ranks high on most indicators of "shareholder protection." Japan, by contrast, has substantial cross-shareholding across firms, so that there is no effective market for control. In Germany, firms are supervised by institutionalized blockholders. In many parts of the world, external shareholders have few protections, while most firms are supervised by closely knit owners, linked by family, ethnicity, religion, or community.

The U.S. pattern is not the typical one. If we measure the concentration of shareholding within firms, or the regulations on shareholder protection, or the rules on board organization, the United States lies at one end of the scale. This was not always the case. In the late nineteenth century, U.S. corporations resembled those of continental Europe. Then policy forced change. The U.S. political system enacted laws against monopolies and concentrated financial institutions and created institutions for the regulation of securities. Other countries did not pass such laws.

This book seeks to explain that divergence. It focuses on the politics of law and regulation concerning corporate structure. There are certainly variables in technology and competition that work regardless of the formal laws, and private bonding or trust mechanisms are quite real. But some important element of what drives the behavior of firms lies in the incentives that law and regulation structure. Explaining law and regulation is thus central to any account of corporate governance.

[1] In March 1602 the Netherlands Republic chartered the United East India Company (Vereenigde Oost-Indische Compagnie, or VOC) as a limited liability joint stock company, the prototype of the listed multinational trading enterprise. Renaissance merchants in Florence and Genoa had experimented with joint stock arrangements before this date, but with a limited term and a "complete contract" between the investors and managers. The VOC, in contrast, raised 6.45 million guilders (over a billion dollars in current terms) from more than a thousand investors, on the basis of an ambitious corporate charter with uncertain return and (initially) a 10-year operating horizon. Arguments among owners, shareholders, and employees regarding the governance of the VOC fill its corporate archives for the 300 years until its demise. See Paul Frentrop, *Corporate Governance, 1602–2002* (Amsterdam: Prometheus, 2002) chap. 2.

Our book is not about recent scandals, though they are important and revelatory and produce considerable suffering in lost pensions and jobs. They also tell us something about how the system works—the scandals are bad for people but good for social science. We do not offer a "how to fix it" analysis, though we have some ideas about the problem. We do offer something essential to a repair manual: a realistic analysis of the politics that shape what actually happens, not just what ought to happen. Politics drives regulations, and regulations shape corporate governance patterns, which then protect or abuse investors. When we design solutions, we have to think about what is likely to happen given political processes, not what is abstractly ideal.

Our motives mix moral with practical concerns. Shareholding provides an important asset for individual and institutional savings. As such, it becomes a vital part of a person's security, life plan, and goals. Widows and orphans, retirees, charities and educational institutions, foundations and nonprofits, along with the wealthy, or the comfortable, or the seekers of pleasure, or people with modest goals—all use securities markets. The ability to attract those savings fuels the economy. Thus we care about "what works" because we care about the aims of people and institutions.

That concern makes us intensely curious. What are the politics of the regulation of corporate governance? We find this topic curiously underdeveloped in the study of firms. There is a rich literature on all the related topics—law, economics, history. Without that literature we could not undertake this project. However, until recently, political variables have not been seriously considered as important elements of an explanation. That is changing as colleagues in several fields look at such variables. We seek to contribute to this growing literature.

Corporate governance, we are convinced, lies at the core of comparative and international political economy. Much of what happens and who benefits is driven by it. Patterns in corporate governance substantially covary with labor markets, education and training, social services, and income distribution. They affect the rates of economic growth and adjustment, the good and the bad. They are intertwined with issues of corruption, the rule of law, and political democracy. They mingle with trade disputes and international economic coordination. Corporate governance is not the sole driver in these areas of policy, but it is an important component, thus important to understand.

We both became interested in this topic well before the recent scandals. Different experiences and reasons brought each of us here. Gourevitch has been studying comparative and international political economy: how countries respond to changes in the international economy and to the pressures they cause. His book *Politics in Hard Times* examined how countries picked policies when faced with challenges of what we now call globalization—the crises of the 1880s, 1930s, and 1970s.

This led to an interest in why countries perform so differently: why, in the 1980s, the U.S. economy was doing badly, while Germany and Japan were doing so well. Gourevitch became convinced that a key element lay in corporate governance, in how firms were run and how they related to subcontractors, banks,

investors, workers. This, rather than the formalized role of the state in the economy (a strong or weak state, the role of the bureaucracy), seemed the key variable. He wrote several papers on this theme.

Shinn came to the topic of corporate governance from a different route—from the bottom up. Over the course of a (checkered) career in business, he worked sequentially as a union employee, a line worker, middle and general manager, chief executive, entrepreneur, then inside and outside director. At the first firm he cofounded, he established and then supervised corporations in 16 countries, including Argentina, Belgium, Brazil, China, France, Germany, India, Italy, Hong Kong, Israel, Japan, Korea, Malaysia, Singapore, Spain, and the United Kingdom. This exposed him to the details of corporate governance "on the ground"—and impressed him (sometimes uncomfortably) with the wide variance in company law, financial reporting standards, and governance rules among countries. He decided to finish a Ph.D. and wrote his dissertation at Princeton on corporate governance and capital market integration in several of the countries in which he had operated as a manager. Some of the material and data in this book draws upon that dissertation.

We discovered our common interest in 1999–2000 at a conference in San Diego, introduced by mutual friend and Gourevitch's University of California–San Diego colleague Miles Kahler, whom Shinn knew when both were Fellows at the Council on Foreign Relations. We decided to work together. We persuaded Les Gelb, then president of the Council on Foreign Relations, that there were international issues in this topic of relevance to foreign policy. He authorized us to run a workshop on this topic at the CFR in 2002–3, which formed the basis of our coauthored *How Shareholder Reforms Can Pay Foreign Policy Dividends*. We are deeply obliged to the participants of that workshop, especially the practitioners from Wall Street, portfolio managers, underwriters, accountancy firms, lawyers, and economists, whose knowledge on corporate governance stemmed from both practical experience and public policy interest, and who were gracious with their (very expensive) time.

Convinced there was much more to say, we turned then to develop this book. We wrote the first draft during 2002–3. Gourevitch had a sabbatical from UCSD that he spent at the Harvard Center for European Studies in 2001–2, and then at the Center for Advanced Studies in the Behavioral Sciences for 2002-3. He thanks these institutions for their remarkable assistance, and the William and Flora Hewlitt Foundation for support while at CASBS. In 2002, Gourevitch published with Michael Hawes an early statement of ideas about the importance of political institutions in shaping corporate governance outcomes. In 2003 Gourevitch developed further some of the ideas about coalitions and alignments that contributed to this book in his *Yale Law Journal* essay, "The Politics of Corporate Governance Regulation," a review of Mark Roe's fine study of this topic.

Both of us mix public policy concerns with empirical ones. We seek here to write a piece of social science—an analysis of reality, an effort to understand, and to develop theories about, why things happen, and to test those theories.

At the same time, we do have practical and ethical concerns about the topic. What corporate governance system is most efficient? Which system promotes growth, protects investors, and at the same time encourages employment and equality of opportunity? We have learned in this project that these variables are interconnected. Those connections influence the politics that shape corporate governance, and more needs to be done to understand those connections.

Many people have helped us with this project.

Peter Gourevitch thanks students in several classes who warmed to the topic, read chapter drafts, did some research of their own, and helped track down references; he notes in particular Jacob Allen, Adriana Bejan, Chris Chan, Willi Hao, and Gonzalo Islas.

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Above all, we thank our ladies and our children for putting up with us for several years as we mumbled and growled and emailed at the keyboard. It has been a pleasure (at least for us), and an intellectual adventure. We thank each other for a fine collaboration; from the beginning to the end, we remain convinced neither could have written the book without the other.

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Political Power and Corporate Control

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CHAPTER 1

Introduction and Summary Argument

Enron, WorldCom, Tyco, Adelphia, Ahold (a Dutch firm), Hollinger (Canadian), Vivendi (French), Parmalat (Italian)—these names have long been staples of the *Financial Times* and *Wall Street Journal*, but more recently they have become scandalous and exotic fare on news dailies and TV networks. Since the Enron scandal began in the fall of 2001, these firms, their bankruptcies, and their miscreant executives have become "above the fold" headlines and evening news clips.[1]

In addition to providing entertainment, these examples of financial failure have graphically demonstrated that there is, in fact, what some delicately refer to as a "corporate governance problem." Scholars and media mavens alike frequently dismissed the corporate implosions that followed in the wake of the financial crises in the mid-1990s—mostly in Latin America and developing Asia—as a regional problem specific to the "crony capitalism" of developing regions. By the turn of the millennium, it became clear the problem was more widespread. Scandals of one kind or another were occurring around the world. At first, people saw Enron as a "one-off" case, a singular event caused by unscrupulous or incompetent people and requiring no special response.[2] As more scandals emerged, however, it became clear that something deeper was at work.

This book is not about these scandals, but about the underlying structures of corporate accountability. We will not try to say why any specific individual abused trust, but rather are interested in the variance among systems of corporate governance around the world. There was a "corporate governance problem" long before Enron and Parmalat. Fiske and Gould were famous nineteenth-century American examples of stock manipulation, with counterparts around the world. Their behavior led to efforts, private and public, to protect investors. Those efforts are the central concern of this book.

Corporate governance is about power and responsibility. It is the structure of power within each firm that determines who allocates money: who gets the cash flow, who allocates jobs, who decides on research and development, on mergers

[1] Media in the West focused on these firms, but Asia and Latin America witnessed a parallel series of high-profile corporate governance scandals, including Korea's SK Corp and LG Card debacles; China's Shanghai Land and Far East Pharmaceutical; Hong Kong–listed CNOOC Finance and China Life; Thailand's Thai Petrochemical Industry; Indonesia's Asian Pulp and Paper; an apparently endless series of Japanese bank abuses; Mexico's TV Azteca; Chile's Endesa/Enersis squabble; and Brazil's COPEL case.

[2] In addition to news stories, this observation is based on comments made over the fall and winter of 2001–2 by participants at a Roundtable on Corporate Governance, organized by the authors of this book at the Council on Foreign Relations, leading to publication of Peter A. Gourevitch and James P. Shinn, *How Shareholder Reforms Can Pay Foreign Policy Dividends* (New York: Council on Foreign Relations, 2002).

and acquisitions, on hiring and firing CEOs, on subcontracting to suppliers, on distributing dividends or buying back shares or investing in new equipment. Corporate governance is also about accountability: who takes the blame for corruption, misuse of funds, or poor performance.

Corporate governance systems reflect public policy choices. Countries pass laws that shape incentives, which in turn shape governance systems. Some countries have rigorous prohibitions on insider trading, vigorous markets for control, strong protection of minority shareholders (rules on accounting, corporate boards, securities), and effective rules for product-market competition and antitrust. These countries have diffuse patterns of share ownership and managerial supervision through boards elected by their shareholders. Other countries encourage blockholding by allowing pyramid leveraging and cross-shareholding, restricting markets for control, limiting competition, and offering weak protection to minority shareholders.

Such different regulatory policies concerning corporate governance turn on political differences among countries—on the interest groups that press for one set of rules or another and on the political institutions that aggregate preferences to produce policies. This book is about choices of corporate governance in countries around the globe. We make extensive reference to the United States, where the give-and-take of interest groups as they press their preferred arrangements for corporate accountability has been particularly visible. American political processes produced the Sarbanes-Oxley bill of 2002, the most extensive U.S. reform of rules on corporate governance in several decades.

Indeed, politics explains the great U.S. "reversal" in corporate governance. In the late nineteenth century, the U.S. system resembled those of Europe: large "trusts" or oligopolies were controlled by shareholder blocks in the hands of individuals and banks; minority shareholder protection was weak, insider trader scandals common. Then laws were passed: the Sherman Antitrust Act in 1890, several laws following the 1905 Armstrong Commission on the insurance industry, the Glass-Steagall Act on banking in 1933, the Securities and Exchange Act of 1934, and now Sarbanes-Oxley of 2002. It is this legislation, regulatory structure, and their enforcement that changed corporate governance in the United States.

In the United States, *interest groups* fought over these laws and regulations: owners; investors as outsiders and investors as insiders; workers as employees and workers as pension fund holders; managers of various kinds; the so-called reputational intermediaries consisting of accountants, lawyers, bond-rating agencies; and institutional investors. These groups fought through *political institutions* whose structure influenced the outcome: the separation of power between the U.S. Congress and the presidency, federalism, political parties, and electoral laws.

These elements of politics—interests, institutions, and political conflict—are in play all over the world. In Korea greater democratization in the 1990s broke the link between the big firms (*chaebols*) and the authoritarian government, leading to rules for greater transparency and accountability in corporate governance, backed by a coalition that included labor, previously excluded businesses, and

regional reformers. In Germany, the various political parties have been battling over legislation that would create markets for control, shareholder rights, and transparency; contrary to most expectations, it is labor and the Social Democrats who are often on the side of the external investors, while the conservative Christian Democrats defend the established insider system preferred by managers and inside blockholders. In Italy, the Parmalat scandal, in France, the Vivendi controversy, and in the Netherlands, the Ahold case have all pushed issues of governance to the fore. The financial crisis of 1997 exposed weaknesses in governance mechanisms for several countries in Asia, particularly in Korea, Thailand, Indonesia, and Malaysia. In Europe, disagreement on takeover legislation and a variety of other measures has slowed development of European Community–wide policies on corporate governance.

Why Fight about Corporate Governance?

That corporate governance provokes political debate should not surprise us. Corporate governance—the authority structure of a firm—lies at the heart of the most important issues of society. That authority structure decides who has claim to the cash flow of the firm, who has a say in its strategy and its allocation of resources. As such, corporate governance affects the creation of wealth and its distribution into different pockets. It shapes the efficiency of firms, the stability of employment, the fortunes of suppliers and distributors, the portfolios of pensioners and retirees, the endowments of orphanages and hospitals, the claims of the rich and the poor. It creates the temptations for cheating and the rewards for honesty, inside the firm and more generally in the body politic. Corporate governance influences social mobility, stability, and fluidity: the openness of economic systems to new entrants and outsiders from established social structures, and the rewards to entrepreneurial initiative. It shapes the incentives firms have to invest in their labor force; thus it intersects with education and training systems, and with social welfare, health, and retirement plans. Corporate governance interacts with hostile takeovers, antitrust, economic competition, international trade disputes, and trade unions. It structures pension systems, social security, and retirement plans.

It is no wonder, then, that corporate governance provokes conflict. Anything so important will be fought over. Anything that shapes wealth, opportunities, stability, and corruption is sure to attract the concerns of the powerful and provoke the anxiety of the weak. Everyone has a stake in the corporate governance system, and everyone has an interest in how it is structured.

We believe that, like other decisions about authority, corporate governance structures are fundamentally the result of political decisions. Corporate governance systems reflect policy choices. They are shaped by a mixture of laws, rules, regulations, and the degree of their enforcement. These laws define the obligations of managers, the rights and duties of owners, the claims of shareholders, and the powers of boards. Researchers often group these rules under the label of

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