

CORPORATE GOVERNANCE

Ruth V. Aguilera
Assistant Professor
Department of Business Administration
College of Business &
Institute of Labor and Industrial Relations
University of Illinois at Urbana-Champaign
1206 S. Sixth St.
Champaign, IL 61820
Phone: 217- 333-7090
Fax: 217- 244-7969
ruth-agu@uiuc.edu

January 2004

Forthcoming (2005) in International Encyclopedia of Economic Sociology, edited by Jens Beckert and Milan Zafiroski. London: Routledge.

Corporate Governance

Corporate governance is the study of the distribution of rights and responsibilities among different participants in the corporation, such as, *managers, shareholders, the board of directors and other *stakeholders (e.g. employees, suppliers, and consumers). This area of inquiry is at the heart of economic sociology as it explores the social relations between organizational actors and institutions that often have conflicting interests. The concept of governing, or ruling with authority and control, is not recognized in neoclassical economic studies or in Adam Smith's invisible hand of the marketplace. Flourishing corporate governance studies have spurred on interdisciplinary research in sociology, economics, law and political science surrounding the relationships between power relations, *financial markets, legal systems, political systems, and product and labour markets.

The study of corporate governance, that originally developed in the context of the *agency theory and is based on the premise of shareholder maximization, has been enriched by economic sociologists and other social scientists who develop two new theoretical and empirical dimensions. First, these scholars have strived to shed light to the different stakeholders in the firm and their relationships. Second, historical and comparative studies have questioned the key factors leading to diverse national corporate governance systems around the world. I discuss each of them in turn.

The Shareholder View of Corporate Governance

The agency theory perspective of corporate governance as exemplified by Michael Jensen and colleagues assumes that firms are dispersedly owned, in line with Berle and Means' 1932 definition of the American 'modern' corporation. The main consequence of dispersedly owned firms is that there exists a separation between the owners of the firm (principals) and those who control the firm's daily operations (agents or managers). As a result, corporate governance is conceptualized around the corporate governance 'problem' where principals-risk bearing shareholders, interested in maximizing their investments-monitor agents—who might be shirking or working towards enhancing their individual interests. Thus, as Shelifer and Vishny

(1997) state, agency theorists aim to understand how investors get the managers to give them back their money (p.738) and hence minimize agency costs.

In sum, agency theory research has devoted a lot of effort to outline the incentives of managers and owners and to identify market mechanisms to minimize potential agency costs. Particularly salient within the management dimension are studies of the role of the Chief Executive Officer, often related to his/her incentives within the firm (e.g. performance related behaviour) and in the *labour market more generally (e.g. career mobility). Finally, agency theory scholars have also paid a great deal of attention to uncover the role of the third point in their conceptualization of the corporate governance triangle: the board of directors. Boards are the intermediary governance body between shareholders and management. In principle, directors' interests are aligned with those of owners as they are elected by shareholders to represent their collective interests in their monitoring of management. Studies of boards of directors in the context of corporate governance examine to what degree different board characteristics such as board composition (insiders/outside directors, board subcommittees, and dual leadership) or *interlocking directorates will minimize agency costs. For example, an insider director might be more likely to pursue managerial interests such as empire building if her compensation is tied to firm revenues.

From the sociological perspective, the agency theory accounts of corporate governance are viewed as *undersocialized for three main reasons. First, the *principal-agent relationship and the assumption of dispersed *ownership overlook the diverse identities of stakeholders within the firm, particularly in the case where the owners are blockholders such as families, institutional investors or industrial banks with socially constructed interests. Second, its focus on bi-lateral contracts discounts the important interdependencies with other firm stakeholders. Finally, corporate governance needs to be understood in an institutional context wider than shareholder rights so that we can better capture the institutional complexity. Hence, social relations and institutional embeddedness also described as actor-centred institutionalism should be the fundamental unit of analysis in examining corporate governance (Aguilera and Jackson, 2003).

Stakeholder View of Corporate Governance

The stakeholder view of the firm based on systems theory has expanded the firm's boundaries by defining firms as 'open systems,' where firm external links are part of every organization. A key factor of this perspective is the recognition of stakeholders (e.g. employees, suppliers, customers among others) and their relationships (e.g. employee ownership). According to this view, firms are not always driven solely by shareholder value maximization because managers may be altruistic about employee empowerment, owners may be concerned about the survival of the firm as in the case of family businesses, and market pressures for profitability are more long term due to the existence of patient capital and the underdevelopment of capital markets. While discussions about suppliers and consumers within the corporate governance equation are scarce, significant contributions exist regarding the role of employees, as exemplified by the important work of Margaret Blair, Mary O'Sullivan, and Mark Roe.

An important contribution to the corporate governance literature is the interaction effects among the different stakeholders competing for limited firm resources. Aguilera and Jackson (2003) discuss three main interactions between owners, managers and employees: *class conflict, insider-outsider conflict and accountability conflicts. Class conflict may arise when the interests of owners and management oppose the interests of employees, particularly regarding distributional issues, e.g. wages. Where owners and management pursue mostly shareholder maximizing interests such as in the U.S., conflict is likely to arise around trade-offs between wages and profits, capital re-investments and paying out dividends, or levels of employment and shareholder returns. Management may often use employee ownership or contingent pay as a means to align employee interests with owners, and minimize governance conflicts. Insider-outsider conflicts may arise when the interests of employees and management (insiders) oppose the interests of owners (outsiders). Insiders may favour internal diversification ("empire building"), block efforts at restructuring, or erect takeover defences to reduce the threat of external takeovers. Insider-outsider conflicts are often acute in Japan due to the intense commitment of capital to specific firms, strong internal participation of core employees, and highly committed management. Insiders' interests conflict with minority shareholders' interests in greater liquidity and financial returns, as well as the interests of certain employees, e.g.,

mobile professionals and non-core employees. Finally, accountability conflicts concern the common interests of owners and labour vis-à-vis management. Shareholders and employees may form coalitions to remove poorly performing management or to demand higher corporate transparency. Here managerial accountability to different stakeholders is not a zero-sum relationship. In Germany, strong labour participation in the supervisory board complements committed blockholders in actively monitoring management. But where the interests of owners and employees diverge too sharply, such coalitions may break down and give management increasing autonomy to pursue its own agenda and thereby damage accountability.

Historical and Comparative Research in Corporate Governance

Corporate governance is best conceptualized when stressing the interplay of institutions and firm-level actors where the underlying assumption is that firms are embedded in multiple institutional settings yet corporate stakeholders and their coalitions also have the capacity to influence firm-level outcomes (Aguilera and Jackson, 2003). The work of Nicole W. Biggart, Gerald Davis, Frank Dobbin, Neil Fligstein and Mauro Guillén are excellent examples of this theoretical setting.

Historical and comparative research in corporate governance sharpens our understanding of the rights and responsibilities between the parties with a stake in the firm because it systematically identifies the patterns of change over time and it uncovers the idiosyncrasies of each national system. In doing so, they also reinforce the importance of different institutional contexts where corporations are embedded as has been illustrated by Peter Hall and David Soskice's (2001) edited volume on the 'varieties of capitalism,' Richard Whitley's (2001) 'business systems,' and Wolfgang Streeck and Kozo Yamamura's (2001) edited volume on the political foundations of institutional complementarities.

The institutional effects on corporate governance are well researched. Institutions including labour markets, financial markets, product markets, capital markets, education and training, and so on are not viewed as self-standing but rather as complementary to each other and mutually reinforcing the corporate governance outcomes. For instance, the traditional lifetime

employment in Japan and firm-specific skills could only be sustained because Japan had generally speaking a closed labour market, enterprise unionism, and financial reciprocity among the firms in a *kieretsu*. If one of the institutions in the constellation were to change, Japanese high employee involvement would transform.

Historical research relies on analysis of **path dependency* as corporate governance change is often incremental as opposed to radical. For example, studies contrasting corporate governance transformations in Central and Eastern Europe from the planned economy period to market economies are an excellent social laboratory to explore corporate governance change.

The internationalization of markets in the 1980s and 1990s triggered an immense and vibrant amount of comparative interdisciplinary research on corporate governance systems around the world and their respective effectiveness. The initial comparative studies contrast the distinctive traits of two main corporate governance systems: the Anglo-American (labelled as outsider, Common Law, market-oriented, shareholder-centred, or liberal model) and the Continental European (also labelled as insider, Civil Law, blockholder, bank-oriented, stakeholder-centred, coordinated, or "Rhineland" model) models.

The Anglo-American system is stylized as dispersed ownership expecting short term returns, strong shareholder rights, arm's length creditors financing through equity, active markets for corporate control, and flexible labour markets. Conversely, the Continental system exemplified by Germany relies on long-term debt finance, ownership by large blockholders, weak markets for corporate control, and rigid labour markets. This classification only partially fits Japan and other East Asian countries characterized by different configurations of **business groups* or the variations within Continental Europe as illustrated by empirical studies describing the pyramidal family-owned firms and weak industry-bank relationships in Italy versus the strong state, bank and foreign capital interventionism in Spain. Despite the rich description found in the existing research literature, the challenge remains in uncovering the key factors explaining national differences.

Hence, comparative corporate governance scholars continue to inquire why corporate governance systems differ quite substantially around the world, and particularly when it comes to two ownership patterns: ownership type (who owns corporations: families, state, banks, floating individuals, institutional investors, etc.) and how much they own (majority or dispersed ownership). Several explanatory paradigms have been offered drawing from different disciplinary fields. For example, scholars from the legal paradigm (or Quality of Corporate Law in protecting minority shareholders), represented mostly by La Porta and colleagues argue that national legal differences, namely common-law versus civil-law legal traditions, are strongly associated with corporate governance outcomes. Other scholars, Mark Roe being its main advocate, focus on the political paradigm. It is believed that national political forces such as party systems or employee job security explain a large part of corporate governance models' variance in advanced industrialized countries. A main finding is that strong social democracy is highly correlated with weak shareholder rights and ownership dispersion. Finally, other scholars have stressed the role of different types of financial systems and their capacity to provide external finance to firms. The work of John Zysman is a good example of this paradigm. Other variables that tend to be included in the corporate governance equation are: degree of state intervention, employee influence, and economic openness.

Conclusion

Initial debates on whether *globalization triggered convergence of corporate governance systems have migrated to questions on the degree of change in corporate governance systems and where the new adopted practices come from. There is a great deal of interest on the hybridization of corporate governance models and the diffusion of practices across national borders. Other areas of corporate governance research that need further attention are the relationship between corporate governance and innovation systems leading to increased competitiveness, the influence of codes of good governance in light of needs for further corporate transparency, corporate accountability, *corporate social responsibility, and the dynamics of corporate governance within multinational firms.

References:

- Berle, Adolf and Means, Gardiner (1932) The Modern Corporation and Private Property, New York: Macmillan.
- Hall, Peter A. and Soskice, David (2001) Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford: Oxford University Press.
- Wolfgang, Streeck and Yarnamura, Kozo (2001) The Origins of Nonliberal Capitalism: Germany and Japan in Comparison, Ithaca: Cornell University Press.
- Whitley, Richard (ed.) (1992) European Business Systems. Firms and Markets in their National Contexts, London: Sage.

Future Reading:

- Aguilera, Ruth V. and Jackson, Gregory (2003) 'The Cross-National Diversity of Corporate Governance: Dimensions and Determinants', Academy of Management Review, 28(3): 447-465.
- Federowicz, Michal and Aguilera, Ruth V. (2004) Corporate Governance in a Changing Economic and Political Environment. Trajectories of Institutional Change on the European Continent, London: Palgrave Macmillan.
- Shleifer, Andrei and Vishny, Robert W. (1997) 'A Survey of Corporate Governance', Journal of Finance, (2):737-783.

Ruth V. Aguilera

[word count: 2,098]