Corporate Governance in Other Countries

Franklin Allen
University of Pennsylvania

Innovation and Regulation in Financial Markets
Federal Reserve Bank of Philadelphia
Policy Forum
November 30, 2007

Introduction

- Which of the following views is the prevalent one in your country?

(a) A company exists for the interest of all stakeholders

(b) Shareholder interest should be given the first priority

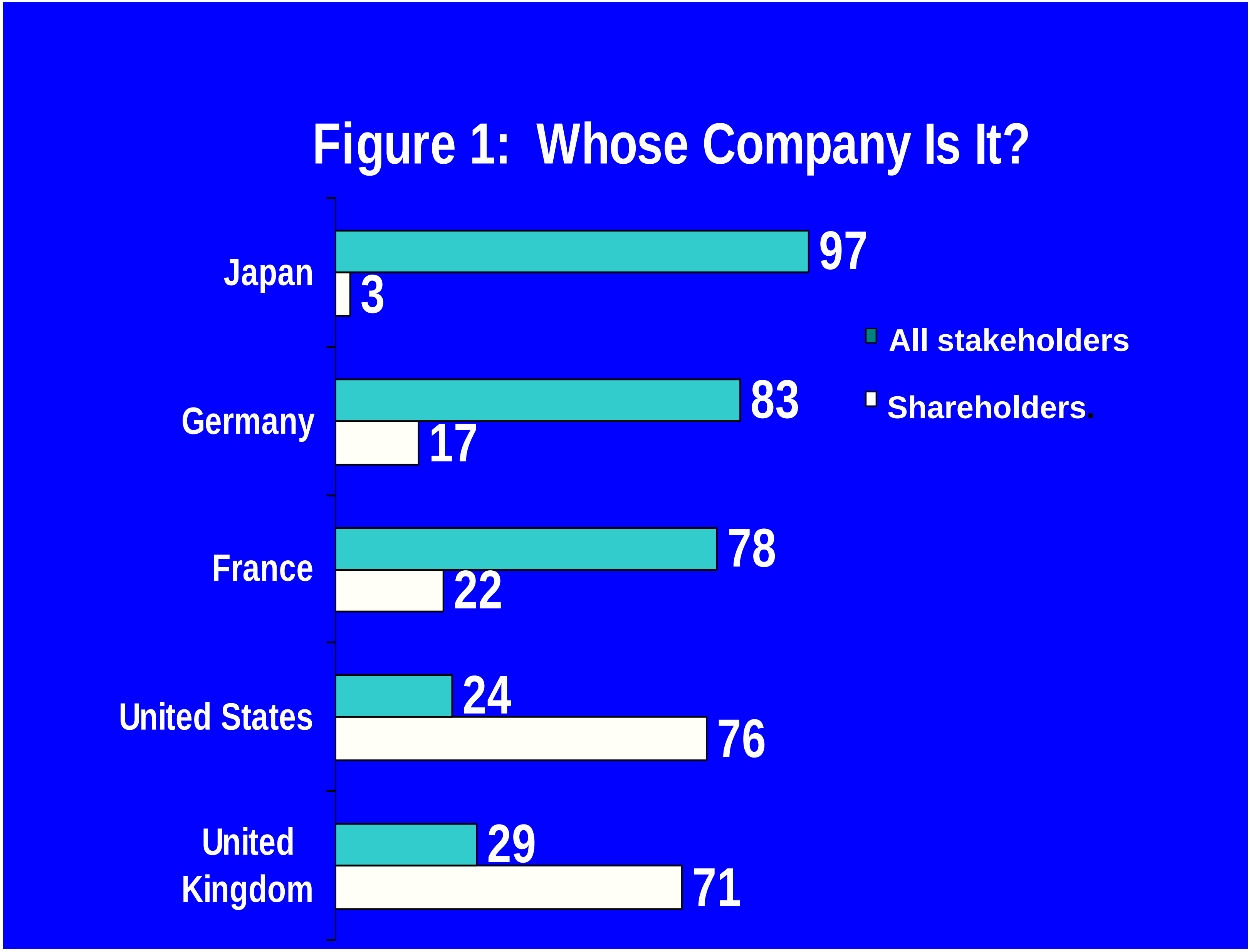


Figure 1: Whose Company Is It?
Japan
97
3
Germany
83
17
France
78
22
United States
24
76
United Kingdom
29
71
All stakeholders
Shareholders.

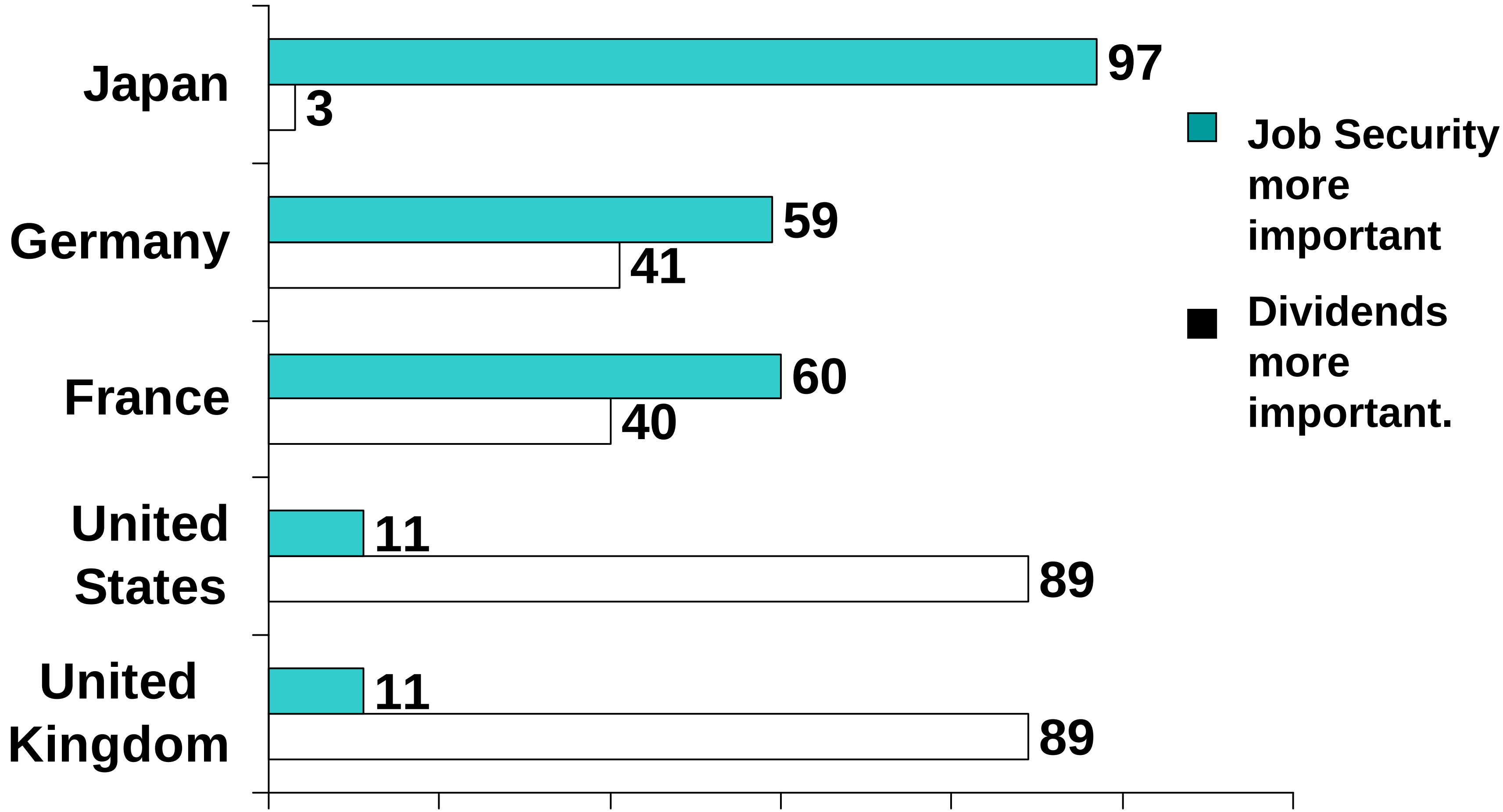
Introduction (cont.)

- Also which of the following two would be the most prevalent view in your country?

(a) Executives should maintain dividend payments, even if they must lay off a number of employees

(b) Executives should maintain stable employment, even if they must reduce dividends

Figure 2: Job Security or Dividends?



In practice…

Germany

- Codetermination: In large firms workers' representatives have half the seats on the Supervisory Board

- Workers' interests are represented in the decision making process

In practice…(cont.)

China

- Has introduced mandatory representation of workers on company's supervisory board

- Too soon to say how it will work in practice

In practice…(cont.)

France

- Firms with an enterprise council must allow workers' representatives to attend board meetings

- This changes the nature of decision making by the board and gives workers some weight

In practice…(cont.)

Japan

- Legally firms are run in shareholders' interest and workers are not represented on the board

- BUT …"It would be irresponsible to run Japanese companies primarily in the interests of shareholders" (Chairman of Toyota, 2001)

Other examples in brief

Mandatory co-determination

- Netherlands, Luxembourg, Sweden, Denmark

Voluntary co-determination: Finland

- Voluntary codetermination with workers' representatives on the board
- 300 companies have introduced it

(also Switzerland and Ireland)

To sum up…

- Great heterogeneity of firms’ objectives across countries

- Stakeholder interests seem to be important in many countries

- But standard corporate governance literature on firms as maximizers of shareholder value
  - That is what firms do in US and UK

What **should** firms do?

- Presumably, they should be run to ensure society’s resources are used efficiently
- What is the best system?
- Well, it depends on the world we are in

Best system?

- In an Arrow-Debreu world with
  - Perfect and complete markets
  - Symmetric information
  - Perfect competition

- Then, maximizing shareholder value achieves efficiency

Best system? (cont.)

- But if we go away from it
  - Incomplete markets
  - Asymmetric information
  - Imperfect competition
- Then, it is not clear that running firms in the interests of shareholders is necessary or sufficient for efficiency
- Allen and Gale (2000) show that altering the objectives of firms can lead to efficiency gains
- Tirole (2001) argues that having diffuse objective functions in stakeholder systems is problematic

Positive analysis

- Allen, Carletti and Marquez (2007)
- How to model stakeholder firms?
  - When they want to assure continuity to their employees
  - When they compete imperfectly
- What is the effect of adopting stakeholder concerns on market value?
- Do firms want to be stakeholder-oriented?

A model of stakeholder capitalism

- One-period economy to start with

- Duopoly with linear demand and constant marginal cost of production c per unit

- Bertrand competition with differentiated products

Two-period model

- A second period is added identical to the first
- But there is a shock to marginal costs in period 1
- A firm operates in period 2 only if profits in period 1 are positive
- Standard shareholder solution

Stakeholder governance

Stakeholder firm problem

Max Profits period 1

+ Expected profits period 2

- Prob bankruptcy x K_i

- Firms take account of the costs employees and suppliers would bear in case of bankruptcy

- K_i is a deadweight cost is the key point

Stakeholder capitalism (cont.)

Result 1

A concern for stakeholders leads firms to set higher prices than in shareholder societies

- Stakeholder societies are further away from perfect competition than shareholder societies

Stakeholder capitalism (cont.)

Result 2

Provided K_i is not too large stakeholder firms have higher first-period expected profits than shareholder firms

- Price above monopoly price otherwise

Stakeholder capitalism (cont.)

Result 3

Stakeholder firms can have higher overall market value than shareholder firms

- Stakeholder concerns soften competition

- Stakeholder firms survive more

Extensions

- Will firms choose to voluntarily adopt stakeholder concerns?
- What is the effect of competition between stakeholder and profit-maximizing firms?
- Cournot vs. Bertrand competition

Concluding Remarks

Stakeholder societies can have

- Higher firm value
- Stakeholders are more secure

But

- Prices are higher

- An important remaining issue is whether stakeholder societies can Pareto dominate shareholder societies and vice-versa