Stakeholders vs. shareholders in corporate governance

Chilosi, Alberto and Damiani, Mirella

Department of Economics-Univeristy of Pisa and Department of Economics, Finance, and Statistics-University of Perugia

20 March 2007

STAKEHOLDERS VS. SHAREHOLDERS IN CORPORATE GOVERNANCE[1]

Alberto Chilosi
Department of Economics
University of Pisa
chilosi@sp.unipi.it

Mirella Damiani
Department of Economics, Finance and Statistics
University of Perugia
mirelladamiani@libero.it

Keywords: *Stakeholders, Corporate Governance, Varieties of Capitalism*

Abstract

The paper is divided in two coordinate parts. The first considers in general the issue of stockholders vs. stakeholders oriented governance systems and their relative merits and demerits. The second part deals specifically with the issue of the principal-agent problem in a stakeholder context.

[1] The paper is the outcome of a common research project on the issue of corporate governance. The authorship of the first part is mainly to be ascribed to Alberto Chilosi, the authorship of the second part mainly to Mirella Damiani.

Part I

Shareholders, Shareholder Value, and Stakeholders

1.1 Two alternative concepts of the corporation and of its governance

1.The corporation belongs to stockholders and in their interest must be run. This conception finds its clearest expression in the shareholder value doctrine, according to which the corporation must be run in the interest of shareholders, creating value on their behalf. Thus the objective of management should be to maximize the market value of the company. This is in accordance, in particular, with the interest of minority shareholders, which should be adequately protected.

2. The corporation must be run in the interest of stakeholders. As the interest of stakeholders is various and contradictory, a compromise between the pursuit of the various interests should be found. This compromise could be trusted to managers (Berle and Means' view), to politicians, to an articulated management board, where the different instances may be represented, leading through their interaction and compromise to the specification of the overall interest of the company. According to the latter viewpoint the corporation can be seen as a community, and as such must be run. In the stakeholders' view may also be included the vision of the social responsibility of the firm, whereby society as a whole is a stakeholder.

The different conceptions have their counterpart in different aspects of corporate law, from the composition and election rules of directors, to the publicity of societal documents, up to the determination of the rules that determine the framework of corporate life, concerning fusions and mergers, takeovers, and the legal framework of capital markets.[2] Of the two conceptions the first seems to be dominant, especially in the Anglo-Saxon environment. In a somewhat different perspective the various corporate institutional systems prevailing in different countries may be seen, whoever are the principals, as different methods to deal with the problem of the separation of ownership and control. The second part of the present paper is dedicated in particular to the consideration of the latter issue in the specific framework of the stakeholder view.

[2] For some discussion of the alternative disciplines see Aglietta, Rebérioux (2005, p. 52 f.), and the literature quoted there.

1.2 Corporate governance and the agency problem

Whatever the actual discipline of corporate governance a large scope for managerial discretion remains, leading to an agency problem, as well as a problem of collective action. This was already well understood by Adam Smith in a famous passage.

"The trade of a joint stock company is always managed by a court of directors. This court, indeed, is frequently subject, in many respects, to the control of a general court of proprietors. **But the greater part of those proprietors seldom pretend to understand anything of the business of the company**, and when the spirit of faction happens not to prevail among them, give themselves no trouble about it, but receive contentedly such half-yearly or yearly dividend as the directors think proper to make to them…The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own….**Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.**"
(Adam Smith, 1776, paragraph V.1.107, bold added.)

In the first part of the passage (in bold) one may notice the reference to asymmetric information, from which the conclusion of the sentence follows. The final result is contained in the last sentence of the passage (in bold).
For many the issue of corporate governance essentially lies in finding a solution to the agency problem.[3] Accordingly to an often quoted sentence, "corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer and Vishny, 1997, p. 737). The sentence relates the agency problem to the shareholder value viewpoint, but the problem exists whoever is supposed to be the principal.

1.3 The normative and positive aspect, and the agency and collective action problems

Both conceptions may have a normative or a positive connotation. The positive viewpoint concerns the issue whether corporations are really managed in stockholder (or some other stakeholder) interest, the normative one whether they should be managed in stockholders' interest, or in the interest of whom should they be managed.
Concerning the positive viewpoint, of what really happens in the real world, there are many who maintain that corporations are mainly managed in managers' own interest, or in the interest of blockholders (control shareholders) rather than, say, in shareholder overall interest.

Two very knowledgeable practitioners who appear to share this opinion are the authors of the following two classical quotes:

"Shareholders are stupid and impudent: stupid because they buy shares, and impudent because they expect to be paid dividends"[4] (Carl Fürstenberg, Famous German Banker, 1850-1933).

"Petit actionnaire minoritaire, petit con, gros actionnaire minoritaire gros con."[5] (Baron Albert Frère, wealthy Belgian businessman 1926-).

Turning to the prominent economists of the past we may add, besides Adam Smith, Thorstein Veblen (1904) and Berle and Means (1932).

Let us consider in particular Veblen's point of view.

"…the men who have the management of such an industrial enterprise, capitalized and quotable on the market, will be able to induce a discrepancy between the putative and the actual earning-capacity, by expedients well known and approved for the purpose. Partial information, as well as misinformation, sagaciously given out at a critical juncture, will go far toward producing a favorable temporary discrepancy of this kind, and so enabling the managers to buy or sell the securities of the concern with advantage to themselves. If they are shrewd business men, as they commonly are, they will aim to manage the affairs of the concern with **a view to an advantageous purchase and sale of its capital rather than with a view to the future prosperity of the concern."** (Veblen, 1904, pp. 156-157, bold added).

The quote is of special present interest, owning to the manipulation of share prices and of accounting values, associated with the great corporate bankruptcies of the past years, and in particular, such as in Enron's famous case, with the objective of cashing in options and speed out of a sinking concern. The passage that we have emphasized in bold deals with a possible serious issue of corporate governance, especially in the case of diffuse share ownership: the dominance of financial over productive considerations, of the short run over the long run perspective. In order to curb the types of behaviour that Veblen laments prohibition of insider trading and of manipulating share values through diffusion of false information have been introduced. However practical proof of wrongdoings may be difficult. An important component of the legislation concerning corporations and financial intermediaries is to contrast managers' tendency to take advantage of their privileged control position to the

---

[3] For a well articulated, if concise, synthesis of all the various ways in which "managers may take actions that hurt shareholders" see Tirole (2001), pp. 1-2.

[4] The original sentence runs as: *Die Aktionäre sind dumm und frech; dumm, weil sie Aktien kaufen, und frech, weil sie auch noch Dividende erwarten.*" (Quoted in Becht, 1997, p. 14.) Biographical information on Carl Fürstenberg is available in the German edition of Wikipedia.

[5] Ibidem. Biographical information on Albert Frère is available in Wikipedia (English edition).

detriment of shareholders, and of control shareholders to the detriment of minority shareholders. The strength and efficacy of this kind of legislation is notoriously lower in continental Europe than in Anglo-Saxon countries. But even independently of the agency issue, there is an issue of collective action that could lead to prefer governance systems where the monitoring of corporations is entrusted to actors with a strong interest in performing it (such as blockholders or fund managers, in case of the shareholder value view; trade unionists, employees' representatives or local politicians in the communitarian view). The agency and collective action problems are only two specific aspects of the issue of corporate governance. However they are relevant for understanding the overall economic and social consequences of different systems of governance. Whatever the latter, the legal rules concerning corporate governance aim to prevent and repress opportunistic and fraudulent behaviour. This kind of intervention is relevant to our discourse, but only as long as its actual specification is dependent on the two alternative conceptions of the corporation we have considered above.

1.4 Corporate governance and shareholder interest

But then, what is shareholder interest?

The simplest and most obvious answer is that shareholder interest lies in the maximization of corporate profit. But shareholders have different time horizons, subjective discount rates and propensities to risk. Moreover the temporal strategy of corporate management can change, even dramatically: for instance a company can change its behaviour deciding to maximize accounting profits in the short run at the cost of their future reduction (goodwill can be cashed in and run down by increasing prices to a level higher than it would be optimal in a long run perspective). Furthermore, future profits are uncertain. Even if we were to know them, what discount rate should be used for determining the present value of a company? This is unclear, owing to imperfections and limitations of the credit market and the intrinsic riskiness of capital investment. However the working of financial markets allows to overcome the above difficulties. The possibility of trading shares provides flexibility, permitting different portfolio allocations according to preferences, while the market continuously values and actualizes future prospects. In the end the maximization of the discounted value of corporate profits can be seen to be conceptually akin to the maximization of the market value of shares.

1.5 Shareholder value (sv)

In a normative perspective the idea that corporations must be run in the interest of shareholders finds its counterpart in the doctrine of shareholder value. (The term has been made popular by a fortunate 1986 volume by Alfred Rappaport, *Creating Shareholder Value.*) Shareholder value creation is shown on the one hand in dividends, on the other in the variation of the value of shares and in stock market capitalization. But the value of shares continuously changes, following the continuous adaptation of expectations, as well as a consequence of short-run events concerning the functioning of the economy (such as changes in monetary policy), irrational herd behaviour and fad-like movements,[6] simple random walk. If a consistent block of shares (or, for that matter, of other financial assets) were to be sold, the price they would fetch would be different, even very much so, from the equilibrium share price that is relevant for marginal transactions. The price of blocks of shares could be lower, but more probably higher than the current share price, especially in case it were to bring corporate control. Moreover, one thing may be the market value of a company in the short run, another in the longer run. Some types of action, such as increasing dividends at the expense of financing investments through retained profits, avoiding risks, but also the prospects of future gains, remunerating managers with stock options, instead than with other more transparent forms of payments, may increase the value of shares in the short run but have a contrary effect subsequently. One could contend that the changes of a company's long run prospects, as engineered by changes in its managerial direction, would correspondingly affect its market values (hypothesis of the efficiency of financial markets). But this is to assume more transparency of information and foresight than realism and experience would allow. On the other hand one could hardly find a better assessment of profitability present and future than the market value of shares.

1.6 Shareholder value and accounting

The shareholder value doctrine has a counterpart in the evolution of corporate accounting, toward the measurement of the shareholder value produced by corporate management, and the determination of the fundamental capability of a company to create value (this means, in the

[6] Cf. Shiller (1987 and 2003).

end, to be profitable). The objective is to achieve transparency of the fundamental data of the company, in the interest of investors.[7]

Aside from the contingent variations of stock exchange capitalization, from the point of view of the underlying fundamentals the economic value of a company can be seen as the present value of the future net cash-flow plus the non-operative assets of the firm (real estate, securities, reserves, etc.). This goes in conformity with Rappoport's famous saying that "cash is a fact, profit is an opinion." However one could also add that if actual cash is a fact, future cash flows are an opinion. The objective of accounting should be to arrive at a reasonable estimate of the underlying value of a company, independently of the changing quotation of its shares, and without the difficulty of having actually to estimate its future net cash flow. Certainly for estimating this underlying value it would not be of much use the consideration of the historical cost of its assets (at the basis of traditional accounting).

1.7 Fair value (fv)

The solution adopted in recent accounting reforms is to extend the concept of fair value, attenuating the recourse to the historical cost of assets. According do the Financial Accounting Standard Board (FASB)[8] fair value is defined as "the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties." The definition, accepted by the International Accounting Standards Board (IASB), is now contained in the International Financial Reporting Standards (IFRS), taken over by the EU. As examples of attenuation of the principle of historical cost we may quote the accounting standard 39 that relates to the introduction of the registration at current or fair values of financial assets, and the accounting standard 16.31 that allows the revaluation of

[7]Aglietta and Rebérioux (2005), who stress the connection between the evolution of accounting principles and the doctrine of shareholder value, criticize the change because allegedly in contradiction with the principles of dynamic accounting, a notion originally introduced by Schmalenbach in 1926. In their opinion it represents a return to static accounting, according to which the valuation of the firm was made in creditors' interest, in times where the relevant notion was the value of the assets in case of liquidation. According to them the concept of dynamic accounting is tantamount with the principle of evaluation at historical cost. But for Schmalenbach dynamic accounting has the task to understand the processes that take place in the firm, the direction of its movement, and thus its prospects and the success of its management, comparing two different states, at the beginning and at the end of the period (cf. Schmalenbach, 1948, p. 9). The degree of success of corporate management may be shown by the variation of the current valuation of the business in time. And this can be measured in conformity with the new accounting rules. Cf. Chilosi (2006).

[8] "The **Financial Accounting Standards Board** (FASB) is a private, non-for-profit organization whose primary purpose is to develop Generally Accepted Accounting Principles in the United States (US GAAP)" (http://en.wikipedia.org/wiki/FASB).

real estate according to the fair value principle: "Under the revaluation model, revaluations should be carried out regularly, so that the carrying amount of an asset does not differ materially from its fair value at the balance sheet date."[9]

1.8 Discretionality of fair value

Historical costs are given, fair values are estimated.[10] The greater discretionality of fair value does not mean that historical cost accounting must be preferred. But the new accounting principles can favour manipulations.[11] For instance derived financial assets such as options can be evaluated in an imaginative way, even more so if they are exchanged over the counter, and valued mark-to-model, as in the Enron case. But the latter is in the end, as in other *cases célèbres,* simply an ordinary case of fraud (extraordinary in its dimension, though), facilitated by specific accounting rules concessions obtained through political lobbying. And fraudulent insolvency has long been a common feature of economic life. The transition of the fundamental criteria of corporate accounting from historical prices to current values implies greater discretionality, since it is easy (even if in many cases not particularly meaningful) to establish how much did the firm pay for something, much more controversial (even if obviously of greater interest) to determine the value of assets with continuously fluctuating market prices, or assets that do not undergo frequent market exchanges, or the market price of which can be hardly determined with some kind of exactitude (such as real estate, and immaterial asset such as a copyright, a trademark, a patent, or the knowledge acquired by ongoing research, or goodwill).

1.9 EVA

The change in the value of the firm in a given accounting period depends not only on how well a firm is run, but also on external factors that affect financial markets as a whole. In order to established the degree of success of managerial activity one must also consider the cost (this means the opportunity cost) of the resources that are invested in the firm. In the shareholder value perspective one should considered the return that could obtained by using the capital of the firm otherwise, in investments having **an analogous risk profile.** Thus we have the concept of Economic Value Added, the original paternity of which is attributed to

[9] Cf. http://www.iasplus.com/standard/ias16.htm
[10] Paraphrasing Alfred Rappoport, historical costs are a fact, fair values an opinion.
[11] On the possible wide diverging estimates of the value of options see Damiani (2006, p. 208); Hall and Murphy (2002).

Schmalenbach, but which in recent times has been formulated by Joel M. Stern, and patented as a trademark by Stern, Steward & Company.

1.10 CAPM

But what does it mean the return on other investments with an analogous risk profile? For this one should refer to the Capital Asset Pricing Model –CAPM (the brainchild, among others, of William F. Sharpe, who because of this too did obtain in 1990, together with Markowitz and Miller, the Nobel Prize for Economics).[12]

According to CAPM, given a whole set of simplifying assumptions, for instance that agents have identical expectations and time horizons, $E(r_i)$, the equilibrium expected return of a security (or a portfolio) i, is equal to the risk-free return (say, of American treasure bills) r_f plus a risk premium that is equal to the expected average market return $E(r_m)$ (where r_m may be represented by the stock exchange index), less the risk free return, multiplied by β_{im}, where β_{im} is a measure of the riskiness of a security i in relation to that of the market as a whole. The greater the volatility of a security (or of a portfolio) in relation to the market as a whole, the greater the return the market requires for compensating its relative riskiness:

$$E(r_i) = r_f + \beta_{im}(E(r_m) - r_f),$$

where β_{im} is given by the following formula:

$$\beta_{im} = Cov(r_i, r_m)/Var(r_m).$$

1.11 The doctrine of shareholder value and option payments

Another possible manifestation of the doctrine of shareholder value lies in the gigantic increase in payments to managers under the form of options, or at any rate tied to the value of shares, particularly in the USA and in the nineties.[13] A possible explanation lies in the diffusion of the doctrine of shareholder value and in the increased awareness of the agency problem: with option payments shareholders' and managers' interests should be made to coincide, which would be especially valuable whenever share capital is dispersed. But there is also an alternative explanation: whenever ownership is dispersed, options make a good opportunity for managers to mask somewhat the taking advantage of their controlling power. According to a view, in Europe those in control of the corporation, be they top managers or blockholders, can benefit of a rent of control that is no lesser than in the USA, but, owing to

[12] Cf. http://www.riskglossary.com/articles/capital_asset_pricing_model.htm; Sharpe (1964).
[13] See Krugman (2002); Damiani (2006), pp. 125, 209-212.

lower protection of minority shareholders may take more obtrusive and fraudulent forms of self-dealing (such as, for instance, asset stripping and transfer prices). This is borne out by the conspicuous additional payments for transferring ownership of packets of shares with control rights.[14] In turn, in the USA until recently option payments were not considered as cost items and therefore they did not reduce accounting profitability. (In recent times however some attempts have been made to take into account their fair value, through a mark-to-model methodology.[15]) Their value is not immediately detectable by the public, and in particular by shareholders, especially since in general options are issued "on the money".[16] At the same time they have a relatively more limited value for managers, considering risk differentiation, and thus they may be equivalent to fixed compensations of lesser value. On the other hand option values do not need to have immediate consequences on managerial incentives in so far as they depend on overall firm performance and not on EVA; managers can cash in options to their advantage even if their firm does not perform any better than the average, whenever the stock exchange grows. If it declines, options are often changed to new strike values (or the on the money date is fraudulently changed, as in the purported recent case of Apple).

1.12. Lean cats may run faster than fat cats.

On the whole it seems likely that huge managerial remunerations have more a distributional than an incentive effect. From an elementary economic theory viewpoint one may consider that the wealth effect of increasing managerial compensation could dominate the substitution effect. Competition in recruiting the best managers could lead to a race towards increased average compensation, but this could result in a negative external effect, producing, because of the dominance of the wealth effect, reduced overall managerial exertion. This negative effect on X-efficiency could dominate the positive effect of allocating the best managers where the positive effect of their managerial capabilities is reputed the highest. Thus

[14] Cf. Dick and Zingales (2004).

[15] According to a 1973 ruling of the Accounting Principle Board (APB, opinion 25) stock options must be included into the accounting books only for the difference between market price of shares and strike price. Subsequently, in 1993, the APB successor, the Financial Accounting Standards Board (FASB), advised registering all options at the fair market value, according to Black and Scholes formula. In 1995 this became compulsory (according to the FASB Statement 123). However, owing to obvious difficulties of that evaluation FASB has in practice allowed companies to carry on according to APB provision. Presently new rules have been introduced by FASB in June 2005. According to them the fair value of options must be recorded at the time of their concession. The whole issue is still debated and in the process of revision, as documented in Bulow and Shoven (2005).

[16] This means the purchase price of the shares is determined at the level the shares are valued by the stock exchange at the time when the option rights are conferred.

increasing the compensation of any top executive officer, for instance, could be associated with negative externalities, by putting pressure on the level of other top executive officers compensation, to the disadvantage of society as a whole, both because of distributional as well as X-efficiency considerations. To curb managerial compensation through direct ceilings could be unwise, since there is some argument in favour of having market allocation of managerial abilities. But there is probably ample scope in practice to pursue the objective by changing the regulations that affect the way through which managerial remunerations are determined. More power could be given to shareholders' (and especially minority shareholders') representatives (and possibly to shareholders themselves through some kind of electronic consultation). More transparency and information as to the actual elements of overall managerial compensation could be required, and possible tax loopholes on participatory incomes could be abolished.[17]

1.13 The alternative view, of the firm as a community of stakeholders, and the Nirvana fallacy

There have been in the functioning of corporations and of financial markets many cases of foul play and instability, stock market roller coasters, and bubbles deflating suddenly, to the dismay of mass of savers. Does this mean that the Anglo-American system, in particular, as founded on the extension of financial markets, and on shareholder value, must be refuted? After all, why should corporations be managed in the exclusive interest of shareholders, who are simply security owners? "Opponents of the shareholder value concept point at various externalities imposed by profit maximizing choices on other stakeholders: on the welfare of management and workers who have invested their human capital as well as off-work related capital (housing, spouse employment, schools, social relationships, etc.) in the employment relationship; on suppliers and customers who also have sunk investments in the relationship and foregone alternative opportunities; on communities who suffer from the closure of a plant; and so forth."[18]

Thus, why not focus instead on the interest of the stakeholders, such as employees, local communities, political actors, or on the interest of the society as a whole, following Berle and Means plea (1932, pp. 352-57), or rather on the interest of the company as a going concern, as

---

[17] On the basis of an argument such as the above one could also envisage to increase the tax burden on high labour incomes whenever it is low. But this, as in the case of curbs on managerial compensation, could lead to some human capital flights, or to a reduction of net human capital imports and reduced incentive of undergoing the costs and trouble of business education.

[18] Tirole, 2001, p. 23.

proposed by some?[19] But what is the interest of the company? How do we define it? After all the company is an immaterial entity, of organizational kind, not blood and flesh, even if it contains blood and flesh. As such, unlike individual stakeholders, the firm has no interests and preferences. And who is entitled to interpret and represent the various stakeholders' interests? The negative aspects of market and shareholder value oriented corporate governance are quite open and well known (we have reminded some of them above). But this does not mean that an alternative system of corporate management founded on stakeholders' interest could lead to better results, without considering in depth its possible overall consequences.[20]

1.14 Managers and stakeholders

As argued by Berle and Means, managers should become "a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity"(Berle and Means, 1932, p. 356), where "public policy" could be the outcome of a program set forth by "corporate leaders", "for example … comprising fair wages, security to employees, reasonable service to their public, and stabilization of business" (p. 356). The obvious alternative is that such a "program" should be set through the political process. But then the power of whoever is in charge becomes all the more arbitrary as the results of corporate activity cannot be assessed, unlike in the case of shareholder value, according to some kind of almost objective benchmark. In the name of stakeholders' interest one may justify nearly every course of action, such as *in primis* the maintenance of unviable enterprises that instead of creating value are value detracting, as the resources they use would be better employed elsewhere. But also financing politics and politicians; the appropriation by employees or of local communities of potential profits through higher wages, higher employment, or organizational relaxation; appropriation of company's resources by managers trough foul play (such as self-dealing and transfer pricing); or may be a bit of everything at the same time, in

[19] See Aglietta and Rebérioux (2005).

[20] The simple consideration that some stakeholders are affected by corporate decisions does not necessarily imply that their interests should be taken into consideration. Every action or inaction usually brings about external effects and may affects some stakeholder (in the widest meaning of the term). But the law does not protect the interest of every affected person. For instance, to make quite an absurd example, my decision to buy or not to buy a new flat affects the interest of the seller, the agent, the solicitor. But this does not mean that I should be compelled to buy a flat just because all these people are negativerly affected by my refusal to buy. Or, more down to earth, matching decisions affect relatives, but the degree to which relatives (in particular parents) are allowed by the law to have a say on somebody's matching

order not to do injustice to the different categories of "stakeholders"; last but not least, simply, bad management. The consequences of stakeholder management can lead to tragic waste, whenever budget constraints are soft, and can be loosened by politicians for pursuing patronage, petty favouritism, or other localized political objectives. Of this in Italy we had many instances, including in particular the ultimate fate of mixed public-private ownership enterprises, where private shareholders had no decisional power, which rested on managers appointed by the government. On the other hand lawmakers' specific vision of the stakeholder view can be incorporated in the norms that regulate the organization and the functioning of companies, and the representation, and representative power, of the different categories of stakeholders in the organs of corporate governance (inclusing such ad hoc measures as government's golden share in some perceived publicly relevant companies). From the exertion of the diffent powers, taking into consideration the overall legal and social framework, the way in which the interest of the different stakeholders are compromised will result.

1.15 Stakeholders' power and markets

But first of all we want to deal with a basic issue: why should managers be chosen by controlling shareholders rather than by the employees, or the trade unions, or, say, local authorities? A first motive is that companies are established by partners signing the original contract leading to firm incorporation (we apologize for stating this very obvious fact, but some discussions on the issue of corporate governance appear to almost forget it). If partners (i.e. shareholders) were denied the power to appoint and direct managers they would lack the motivation to found and finance the company. It is true that in many cases existing shareholders are not the original partners, but the possibility to eventually transfer their property rights in the firm, selling the shares of the firm on the open market ("liquidity"), constitutes a powerful inducement to found the firm in the first place. Whenever shareholder interest (and especially the interest of minority shareholders) is better protected the extension of financial markets is greater, and the financing of firms, as well as the control of the way they are managed, occurs in a relatively more transparent manner through the market. Selling firms in parts or in their entirety is easier. Hostile takeovers, whenever they are effectively

---

decisions varies across different cultures. In our culture parents of adult partners have no rights in this respect, elsewhere it is often contrary the case.

possible, may perform as a disciplining device, and possibly lead to a more efficient management of resources and higher growth.[21]

1.16 Financing through the market vs. bank credit

The opposite takes place whenever (as in the "continental" model) the protection of shareholder rights is lower, and financing through bank credit is more relevant, as financial markets are thinner. Of course bank credit has a number of possible advantages: better knowledge of the situation of firms and therefore better monitoring by bankers than by most shareholders, increasing returns from bank activity through pooling of information. But there are also perceived disadvantages, such as lesser propensity towards financing risky investments, among others because lower division of risk. (The cost of giving and managing a loan is certainly much larger than that of purchasing and keeping a variable amounts of shares. Any individual shareholder may have a modest amount of shares of any company, and shareholders are many. A company on the other hand usually deals instead with a very limited number of banks.) A consequence can be in continental Europe the lack of venture investors and business angels, available to finance risky investments with the aim of liquidate their investments by getting public. This is common practice in the USA, where it is made possible by the existence of a vast liquid financial market that facilitates new underwritings. The limitations in equity financing may put a heavy toll on the creation of innovative firms. As Tirole (2001, p. 20) puts it, contrary to the polar case of established firms in mature sectors, "a high-tech start up usually generates little or no income for a long while and must therefore be financed mainly through equity; short- and medium-term debt would create serious liquidity problems." Moreover the option of going public favours the growth of successful enterprises. It can also be a smooth way to solve the problem of generational transition of family businesses, and of the need to more or less gradual transfer of corporate control, due to aging or reduced interest by the original entrepreneurs. In a shrinking world with high capital mobility, limitations to the extent and articulation of financial markets, and lower shareholder protection may result in a greater tendency to portfolio investment outflows abroad, especially towards countries where the contrary applies (example: the inflow of capitals into the American financial market that, among others, contributed to finance the speculative bubble of the late nineties; relatively little power of attraction for foreign investments by Italy).

---

[21] But it may also have negative consequences. On this, as on other specific points, one is referred for the more comprehensive treatment to the second part of the paper.

1.17 Shareholder value and the social function of profit

But the fundamental motive in favour of the principle that companies must be managed in shareholder interest is that shareholder interest directs firms' activity towards profit formation, instead of alternative objectives, such as those we have mentioned above related to the pursuit of stakeholders interests, or simply of carrying on production for its own sake. And the pursuit of profit is in the interest of society as a whole, provided of course that it occurs in the framework of a whole set of legal constraints that take into account the external effects of economic activities, as well as countering market failures and preventing opportunistic and fraudulent behaviour. Moreover, as any other human activity, one should expect that in the pursuit of profit some kind of basic moral principles should be observed, even if their exact definition could be highly controversial. The same applies to etiquette and some sense of social responsibility (taking into consideration the consequences of one's actions on everybody else) that should apply to corporate as well as to personal behaviour, and which not necessarily is contrary to the profit motive, at least in a long-run, repeated game, perspective.

Basically, profit is the difference between measured revenues and measured costs. Even if this provides a very imperfect measure of the social benefit of an economic activity, still it is better to have a very imperfect measure than none at all, and no obvious alternative is available. Moreover profit provides a motive as well as, independently of the acceptance or refusal of the shareholder value principle, a source of the growth of the firm in a market economy. Profitability conditions the extent of external finance, be it from bank credit or from financial markets (Damiani, 2006, p. 136). Furthermore, whatever the governance system, reinvested profits make on the whole the principal financial source of firm expansion. Some do infer from this that size and liquidity of the financial markets should not matter very much and that shareholder rights can be limited in corporate governance without much affecting the growth of the firms, since the greatest bulk of transactions involve existing shares changing hands rather than financing firms through issuance of new shares. Here we can make an analogy with the estate market. In the real estate market the bulk of transactions involve selling and purchasing existing estate, rather than building new one. At any moment of time the set of houses is independent of property rights (alike to the sets of companies and of physical capital): you can instantaneously change the nature and distribution of property rights in real estate (you could instantaneously change the extent of shareholder property rights) and in the short run the available housing stock does not change (the set of existing companies and of physical capital does not change). But in the longer run the amount and the quality of available housing changes a great deal, since changing property rights in real estate changes the incentives towards construction, maintenance and efficient allocation (changing shareholder rights changes the incentives for firms being created, managed and grow).

1.18 Shareholder interest and profit making vs. stakeholders interest and loss making in air transportation.

Let us consider a very clear cut case: Alitalia vs. Ryanair. Where does the social interest lie? Which one has acted in the best interest of workers (if we consider also the large number of workers who take advantage of cheap flights by Ryanair)? Alitalia is an emblematic case of a loss making and shrinking company, acting in the pursuit of some stakeholders' (in particular employees' and politicians') interest, destructing instead of creating value. Ryanair is a competitive, highly profitable, fast growing company, dramatically increasing the supply of cheap transport services for everybody concerned: Bye, bye Alitalia!

1.19 Employees as stakeholders, workers' interest, and the fallacy of composition

Let us in particular consider the interest of those very special stakeholders, the employees.
From the above mentioned case of Alitalia vs. Ryanair one may well understand that workers' interest in general does not necessarily coincide with the interest of the employees of a given firm to have higher wages than elsewhere, more relaxed working conditions, and de facto tenure in the job. But would workers' interest in general be favoured by having employees' representatives as significant participants in the governing boards of any given firm?
At first sight one would see an affirmative answer as obvious. But this would not take into consideration that in **every single firm** employees' representatives will presumably try to act in the best interest of the employees of **that given firm.** To think that from the pursuit of employees' interest of **any given firm** the pursuit of workers' interest in general follows is an example of the fallacy of composition. One may also note that in the prescriptions of the labour code employees' interests are taken into consideration and protected. It is not at all obvious that an additional defence in the area of capital governance would be suitable and useful.

1.20 Insiders vs. outsiders and the fallacy of the independence of quantity on price

The pursuit of insiders' interests could (even if not necessarily should: see in particular the reference to the German case below) lead to a slowing down of the growth of firms, as a consequence, say, of higher wages and lower profitability, and to worse allocative efficiency.

This could be to the disadvantage of the outsiders who otherwise could take advantage of the growth of the firm, as a consequence of higher employment and a greater and cheaper supply of goods and services (Alitalia vs, Ryanair case). The result could be higher unemployment and lower living standards for the unemployed, and for those employed in firms with lower productivity and lower wages. To the extent that any employment reduction would be resisted, this could lead to the blockage of the mechanism that through the market (including the market of corporate control) leads to the transfer of resources, labour in particular, from where they are less productive to where they are more.[22] In the middle-long period at least, wage and employment dynamics may be negatively affected at the level of the economic system as a whole.

1.21 The issue of scalability and the weight of organized interests

Particular categories of insiders are top executive officers and control blockholders. Interventions to their advantage (as well as to the advantage of employees fearing that takeovers could result in redundancies) are those reducing the scalability of corporations (particularly, as is often in practice the case in Europe, if the takeover bid comes from abroad). In some countries the joining forces of organized insider interests, managers, blockholders, local authorities, employees, banks can lead to stagnation and bad utilization of productive resources.[23] The recent relative stagnation of German or Japanese economies could be partly explained in this Olsonian perspective, as a consequence of the concretion of pressure groups and organized interests.

A justification of restricting the possibility of hostile takeover bids is that if management is all the time exceedingly preoccupied with fending off the danger of hostile takeovers, and thus with current stock exchange values, this could lead to excessively shortening of time horizons, reducing interest and attention for long run programs.[24] This tendency is often considered a

---

[22] Of course, owing to faulty market signals, the substance could be different from the appearance, But on this subject we may refer to what has been said above relatively to the function of profitability and the nature of market signals.

[23] A way in which the interest of stakeholders can assert itself is by pressing for legislative intervention limiting companies' contestability and scalability. This has taken place towards the end of the eighties in the United States, after the Reagan administration devolved at state level the competences in corporate legislation, resulting in new legislation curbing hostile takeovers. This is translated into the drastic reduction in the percentage of hostile acquisitions in the nineties in relation to the eighties (cf. Damiani, 2006, p. 182).

[24] The quote from Veblen above seems here to the point. Moreover the stock exchange capitalization may be depressed not only as a consequence of ineffective management, but also because of contingent and even irrational factors not economically justifying as such a

disadvantage of the Anglo-Saxon public company system in comparison to the continental or Japanese system of corporate control by insiders and banks. Indeed, the empirical inquiries as to the effective results of takeovers are rather ambiguous and contradictory.

1.22 Possible positive consequences of employee representation in corporate governance bodies

Control by empowered employee representatives could contribute to hold in check the possible tendencies to opportunistic and self-dealing behaviour by top managers and control shareholders. Employee representation in governance bodies could also improve the quality of accounting documents, with positive consequences, among others, for fiscal transparency.[25] It could bring about a better climate of industrial relations, among others as a consequence of some greater identification of the interest of employees with the interest of the firm. There could be better trust that disclosing preferences and transmitting valuable information by employees would be used to their benefit too, and thus it would stimulate the transmission of valuable information inside the firm.[26] A consideration often heard concerns the protection, and thus stimulation, of employees' firm specific investments. Alternatively, the protection of firm specific investments by employees can be engineered on the one hand by the interest of the firm towards building a reputation, and on the other by labour law provisions, in particular those protecting employees against unfair dismissals. It is by no means obvious that firm specific investments by employees, who could because of this aspire to a higher remuneration, would find adequate protection through employee representation in governance bodies (or for that matter through trade union representatives): Owing to possible egalitarian bias, or to the relative numerosity of employees with relevant and of those with little human capital, be it general or specific, employee representatives could be biased in favour of the interest of those who did not make, or made lower than average, specific investments, and, on this account, could not look forward to receive an additional remuneration.

1.23 The case for mandatory employee representation

The case for mandatory employee representation in corporate governance bodies may depend on the balance of two possibly contradictory effects. On the one hand some degree of involvement of employee representatives in corporate governance could be beneficial for

---

change of management, but leading to a hostile takeover anyway (the high transaction costs and the length of time involved may however reduce this possibility).

[25] Cf. with reference to the specific German case Jackson et alii, 2004, p. 34.

overall productivity and value added creation, on the other it could affect the distribution of entrepreneurial surplus to the disadvantage of employers. If the second effect dominates the first, it will be in the best interest of employers not to establish employee representation in the corporate governance of the firm, if only in the form of workers' councils, while it could be in the general interest to establish it if by so doing overall firm surplus could be increased.[27] To this argument three types of objections could be raised. First, it could be difficult in practice to determine what degree, if any, of employee representatives' power, would maximize, or simply affect positively, overall firm surplus. In particular a general legal provision would not be able to discriminate between the different firm specific circumstances. Second, the previous argument against the enhancement of insiders power, that it could be exerted to the detriment of outsiders and the general public, would still apply. Third, the reduction of employer power may reduce the incentives to become employers. Supply of managerial talent and capabilities could (but not necessarily would) suffer, and this could affect, among others, the overall demand for labour.

1.24 The German case

The positive aspects of employee representation in the corporate governance boards (from one third to half the members of the supervisory council) may have contributed to the success of the German model. An important effect could be to enhance employees' collaboration in hard times. Without the specific German aspects of corporate governance it would have been probably difficult to get employees' agreement toward increasing the work time with unchanged wage, as has been recently the case in some German automotive factories. But the positive past performance of the German economy and of the German specific features of corporate governance could be partly explained through the specific features of German society, in particular the high level of social capital (in the sense of Bourdieu-Coleman). It is far from obvious that the same would take place in case the German system were to be imported elsewhere. Moreover the German economic performance has worsened after the re-unification: the specificities of the governance system, geared to insider protection, may have hindered the ample restructuring processes required by the dislocations of the internal, as well of the international, opportunity costs, and by rapid technological change.[28]

---

[26] Cf. Freeman and Lazear, 1994, pp. 15-16.
[27] Freeman and Lazear (1994).
[28] Cf. Damiani, 2006, p. 126.

1.25 Institutions and the social framework

Analogous considerations can be made with respect to the possible export of any given corporate governance system, and of the institutions of modern capitalism. This is obvious in particular in the case of Russia in the nineties, when independent and responsible institutions of financial market control and corporate management supervision were all but absent, shareholders' rights were disregarded by those who were legitimately or illegitimately in control, and there was no adequate law and order enforcement. In this case too it is not possible to conclude as to the consequences and suitability of specific institutions without considering their interrelation with the social environment.[29] One must always be careful to shun the Nirvana and composition effect fallacies, and avoid being content with what seems obvious, but it is not really true.

1.26 In the end: what happens in practice?

Some research has been dedicated to the issue of the overall economic consequences of alternative systems of corporate governance (see in particular Gugler, 2001; Maher and Andersson, 1999), but the outcomes have been mostly contradictory and ambiguous, such as not to allow strong and definitive conclusions.[30] This could lead one to think that, in the case of corporate governance too, the performance of institutions depends on the social environment and that there is a tendency for institutions to adapt to the environment. Or, may be, that analogous results can be obtained through different institutional set-ups. Thus, the issue remains open and requires further study.

---

[29] Here the notion of institutional complementary may be relevant (see Aoki, 2004, p. 33), as well as the role of the interrelation of formal and informal institutions as expounded in Hall and Soskice (2001a).

[30] A synthetic review of the empirical studies in this area, see Damiani, 2006, pp. 102, 104, 110, 123-126.

Part II

The Principal-Agent Problem in a Stakeholder Context

2.1 Introduction

As noticed by Blair (1995, p. 214), even in the United States, a country less oriented to the stakeholder view, "by the late 1960s and early 1970s corporate responsiveness to a broad group of stakeholders had become accepted business practice". In particular, new theories of the firm suggest "a view in which the relationship among the people who participate in the production activity of firms are at the heart of the definition of the firm itself" (Blair, 1995).

This new perspective gains relevance when firm-specific human capital investments are the source of 'power', as suggested by Rajan, Zingales (1998) and when 'animate' assets become the critical resource of the firm. In this new scenario, institutional arrangements to elicit effort and contribution are complex and qualify the firm as an incentive system" (Holmstrom, Milgrom 1994).

2. 2 How to solve the stakeholder principal agent problem

As well known, the various corporate institutional systems prevailing in different countries may be seen as different solutions to the problem of the separation of ownership and control. They try to design alternative methods to deal with those problems. Some surveys, as Prowse (1995); Maher, Andersson (1999); Allen, Gale (2000), Gugler (2001), Becht, Bolton and Roell (2003), Denis, McConnell (2003), offer a detailed documentation of these 'varieties' of capitalism.

The Anglo Saxon economies, characterized by dispersed ownership, are systems where individual investors have little incentive for active governance. However, in these economies where the single agent has not enough power or incentive to detect and contrast inefficient management, alternative forces may play a disciplinary role. Takeover threats, managerial incentives, effective boards may mitigate the moral hazard problems affecting corporations (Shleifer and Vishny, 1997).

But how do these mechanisms work in aligning the interests of stakeholders and those of their agents? And can the alignment motivation, behind the endorsement of a stakeholder society, conceal, instead of mitigating, managerial misconduct and moral hazard problems?

2.3 The market for corporate control and the management-labour relationship: cooperation or collusion?

Many studies have stressed, but only in a shareholders' perspective, the crucial relevance of the external threats from raiders to induce greater loyalty from managers and favour an alignment of interests with their 'principals', especially when dispersed ownership impedes a direct monitoring over the 'agents'.

Leading examples of Anglo-Saxon systems, where not individual owners but market mechanisms ensure efficient managerial conduct, are represented by the United Stated and the United Kingdom. As shown in Table 1, in these two countries, where a larger fraction of firms are widely held and market capitalization is higher, the incidence of hostile bids is more significant, thus showing that the dominating force which shapes the governance mechanisms is not the individual controlling shareholder, but the market. Misconduct of managers, who waste resources and pursue unprofitable projects, is reflected in declining share prices, which favors hostile takeovers.

Managers of a publicly listed firm, who know that the company may be subject to takeovers and in that case could be fired by the new owners, are encouraged to adopt profit strategies more oriented to maximize shareholders' wealth (Manne, 1965). The threat of management replacement thus improves investor protection.

Table 1: Ownership dispersion, market capitalization, takeovers

	Firms widely held (as percentage of total firms) (a)	Average Market Capitalization of Firms (millions of $) (b)	Hostile bids (as percentage of total deals) (c)
US	n.a.	71,650	6,34%
UK	63%	18,511	4,39%
Germany	10%	8,540	0,30%
France	14%	8,914	1,68%
Italy	13%	3,140	3,04%

Source: (a): Faccio, Lang (2002): 1996-2000; (b): La Porta et al. (1998), (c): Rossi, Volpin (2004), 1990-2002

However, the effectiveness of a market-oriented device to reduce managerial discretion may not be ensured for a number of reasons, as reviewed in Damiani (2006).

First of all, in hostile takeovers a free riding problem emerges. In fact, 'if a shareholder thinks that the raid will succeed and that the raider will improve the firm, he will not tender his shares, but will instead retain them, because he anticipates a profit from their price appreciation' (Grossman and Hart, 1980). In this context, where control is a *public* *good*, the internalization of the benefits of collective action is hindered by the tendency of individual shareholders to avoid monitoring costs and to take advantage of monitoring activities performed by other shareholders[31].

Secondly, there is an ex-ante inefficiency: hostile takeovers threats and rent expropriation may induce to undertake sub-optimal level of investments. Fear of a hostile bidding may lead to negative outcomes such as management entrenchment and short- term oriented behavior.

Thirdly, the beneficial effects of takeovers, as mechanisms to transfer control from an inefficient management to an efficient one, may not be achieved when the primary reason for bidding is not efficiency improvement. In these cases, as suggested by Jensen (1986), takeovers solve free cash flow problems, but not the agency problem. This happens when bidding actions are undertaken to pursue growth objectives that benefit managers of the buying firm, rather than to improve the efficiency of the corporate target. As stressed by Shleifer and Vishny, "a fluid takeover market might enable managers to expand their empires more easily, and not stop excessive expansion of empires" (Shleifer and Vishny, 1997, p.756).

The relevance of these forces, which has been evaluated for a long time in a hotly debate on takeovers, may now be reconsidered in a stakeholder perspective.

Consider the following story (Hernández-López, 2003). It refers to two well-known luxury goods firms, LVMH and Gucci and involves LVMH's bid for Gucci, with Pinault-Printemps-Redoute serving as Gucci's white knight.

> *In 1999 LVMH begins its bid for Gucci, as Gucci has reached financial success and its popularity has climbed. Something very different from the "managerial misconduct" motivation suggested by Manne.*
>
> *"At first, LVMH explained its investments were "passive," "strategic," and did not represent a bid for Gucci. … by January 26, 1999, LVMH reports to the SEC that it had invested $337.5 million to attain 34.4% of shares in Gucci. … Knowing LVMH's reputation and because it was its main competitor, Gucci interpreted LVMH's investment as a hostile bid."*
>
> *"On February 18, with an ESOP, the Gucci board issues 37 million common shares to Gucci employees. The effect of the issuance would be an additional number of shares in Gucci's capital stock. Additional shares diluted LVMH's voting power. LVMH now only had a 25.6% stake in Gucci. Theoretically with the new shares issued, Gucci could mitigate the LVMH threat."*
>
> *"LVMH responded by suing Gucci … The raider claimed that the ESOP was illegal, because the ESOP's only objective was to limit LVMH from attaining more shares, and the ESOP had no benefits for the employees. Gucci's legal defense was the ESOP was enacted because the board feared for the company's 'future well-*

[31] It must be added that the effectiveness of a market for corporate control is not ensured when competitive conditions are not prevailing in product and financial markets, and share prices are not good signals of firm performance. This implies that good corporate governance must be accompanied by pro-competition and anti-trust legislation.

> *being, interests and independence of the company, its employees, independent shareholders and other stakeholders.' Issuing shares to the employees guaranteed employees received an interest in the company and control of the company lay with the interest of labor. " (Hernández-López, pp. 152-156)*

The Gucci story shows that the assumed interest of the employees may be invoked as a deterrent to hostile bids, and that an instrument of labour relations such as ESOP may perform as a hidden new powerful anti-takeover device. As a coincidence, exactly at the time of the battle between the two luxury goods firms, in 2000 Hellwig writes that managers and stakeholders may become indeed "natural allies".

Some years later, this intuition leads Pagano and Volpin (2005) to formalize a general model where anti-takeover alliances between all the agents (individual shareholders, management, and workers) satisfy their incentive compatibility constraints. They show that the adoption of employee share owners plan (ESOP), as well as the bargaining of generous long term wage contracts, may reduce the attraction of hostile bids, thus rendering unassailable corporate control.

Efficiency wages, as an incentive device to elicit effort from employees, is one of the main issues of labour economics. But this approach has always implicitly assumed that owners and management have similar interests vis-à-vis employees. However there could be alternative governance coalitions, for instance concerning the relationship between managers and workers. This is exactly what Pagano and Volpin intend to reconsider. Incumbent managers may elicit effort with two different strategies: generous wage payments or strict monitoring of workers activities, but these two policies are very different in terms of managerial preferences. The cost of the first strategy is borne by shareholders, the monitoring cost is borne by the manager himself.

Secondly, manager's optimal conduct, aimed at maximizing his private benefits, rather than shareholder value, is conditioned by raider's choices and employees' reactions. Indeed, the raider, who usually purchases a "toehold", may succeed in acquiring the target firm by offering to dispersed shareholders a bid-price at least equal to the after takeover price. The increase of the latter will be obtained by cutting wages as possible and increasing monitoring activity; therefore the raider may induce a substantial increase of share price, and gains from the possession of his toehold shares. But this prospective scenario, where employees' welfare deteriorates, induces workers to ally with their incumbent management. On his part the owner of the target company tries to align the interests of management with his own interests and thus provides incentives to his executives via inside equity. However, if managerial private benefits from wage concessions and a quiet life, on one hand, and takeover costs, on the other, are sufficiently high, neither internal incentives, nor takeovers may solve the moral hazard problem.

To summarize, three main elements are the ingredients of the "natural alliance" between managers and workers.

Firstly, wage bonuses and stable relationships transform employees into *shark repellent*, as Pagano and Volpin suggest, thus reducing the convenience of the bids for the potential raider. Under employment protection rules, long term labour contracts are signed and the raider cannot succeed in renewing these arrangements, and in wage cutting.

Secondly, employees become *white squires*, since they assume an immediate interest in contrasting hostile acquisitions, for instance via strikes and a strong opposition to the deal, thus performing the same role of those investors that, purchasing an interest in the target of a hostile bid, may succeed in deterring takeovers.

Finally, managers, by simply providing wage premiums and long term contracts, may forgo all those riskier and effort demanding strategies represented by investment, plant acquisitions and plant destructions, just to name some the few strategies of the empire-building models of managerial preferences (Baumol, 1959, Marris, 1964). A weakening of raiders' hostile activity permits high wages for employees and less monitoring effort for their management, "very much, as in Hicks's (1935) suggestion that the best of all monopoly profit is a *quiet life*", as reminded by Bertrand and Mullainathan (2003, p. 1047).

This thesis fits well with the Gucci story and can be formalized with an analytical model where entrenchment strategies may reveal credible threats. Furthermore, the same thesis can be tested, quite naturally, to explain the experiences recorded in the US, the country where during the 1980s almost a quarter of the large US corporations has received a hostile bid (Mitchell, Mullherin, 1996). Indeed, the empirical analysis performed by Bertrand and Mullainathan (1998) for the years 1976-1995 by using COMPUSTAT and LRD databases shows that an increased attention to employees does not improve the efficiency of the American firms, especially in those firms incorporated in states with anti-takeover laws. On the contrary, it is exactly the approval of state-level anti takeover provisions that permits an increase in average wages up to the figure of 4% for white collars, without impact on labour productivity nor on investments and firm size. In sum, stakeholder protection does not "pay for itself", a result which should call for a better regulation of hostile bids and for company laws more oriented to prevent the adoption of anti-takeover devices, sometimes hidden under the umbrella of stakeholders' interests.

But now listen to a second story, as told by Shleifer and Summers (1987, pp. 3-4):

> "*Carl Icahn takes over USZ. He closes down the corporate headquarters and lays off thousands of highly paid senior employees who had previously been promised lifetime employment by the now displaced managers. He also shuts down the factories which dominate several small towns. As a consequence numerous stores, restaurants and bars go bankrupt. The stock of USZ goes up by 25 percent…The gains to USZ shareholders are offset by losses incurred by laid off employees and by the firms with immobile capital whose viability depended on the factories remaining open. And other firms find that their workers seeing what happened at USZ become less loyal and require higher wages to compensate for a reduction in their perceived securities. They also find it more difficult to induce suppliers to make fixed investments on their behalf.*"

The above case is representative of the massive acquisitions wave undertaken in the 1980s in the US. In that period, the actions of raiders such as Icahn, Boone Pickens, Goldsmith, Perelman, Campeau, motivate books as "Barbarians at the Gate" that turned into bestsellers (Tirole, 2006, p.43). In any case, a more serious approach, as that promised by Jensen and Ruback (1983), in their paper "The Market for Corporate Control: The Scientific Evidence", reveals a recurrent feature of hostile bids. Takeovers do not create value but have distributive effects that favor target shareholders, without enhancing the acquiring shareholders and with ambiguous effects on social welfare. After all, as suggested by Shleifer and Summers (1987, p. 23), "it is hard to believe that Carl Icahn simultaneously has a comparative advantage at running a railcar leasing company (ACF), an airline (TWA) and a textile mill (Dan River). It is more plausible that his comparative advantage is tough bargaining and willingness to transfer value away from those who expect to have it."

The vast literature devoted to evaluate the takeover consequences has shown that in the US the average premium returns of the target shareholders have been in the range between 15 to 30 per cent (Andrade et al. 2001). On the other hand, there have been negative or no significant effects on bidder returns (see Andrade et al., 2001, Stulz et al. 1988). But these findings should be reconsidered in a more open perspective, where efficiency and welfare considerations are evaluated in the long- term.

The mere calculations of the abnormal cumulative returns of price assets of target and acquiring firms may not capture the 'reputational externalities' associated to hostile takeovers and their serious allocative effects. This comes true not only because stakeholder losses are harder to measure than shareholder gains, but also because in an extended view, the firm is a sort of nexus of long term contracts between shareholders and stakeholders. Many of these contracts are implicit and self -enforcing, since they lie on the mutual trust of parties (Macaulay, 1963, Williamson, 1985) and "such trustworthiness is a valuable asset of the corporation", as remind us Shleifer, Summers, (1987, p. 7).

In this context, the apparently well functioning of a market for corporate control represents a menace for this valuable asset, since it destroys those nexuses of long term relationships and intangible assets represented by the firm's reputation (Kreps, 1984). In other terms, a hostile bid may represent a *breach of trust* (Shleifer, Summers, 1987), a more serious damage that does not only have *ex-post* distributive effects, but that may reduce the *ex ante* incentives of the potential stakeholders (employees, suppliers, subcontractors) to invest in relation specific capital.

This negative side -effect, as suggested in Chemla (2005), should be properly considered by seeing that in the absence of takeovers, stakeholders' bargaining power increases their incentive to invest in the firm, even if, on the other side, it may reduce owners' incentive. Direct evidence on the effect of takeovers on stakeholders' relationships is difficult to obtain; however, Chemla suggests that trade credit may reveal significant aspects of long term (implicit) contracts with trading partners. For instance, the findings shown in Mayer (1990, p. 312), show that in Japan, where more relevant are inter firm and long term relationships than in the US and the UK, firms use more trade credit[32], while in the other two countries, the market for corporate control is more active. One of the potential rationale behind these results is that "suppliers who have blocks of shares in firms are more likely to extend trade credit, and at better terms than other suppliers" (Chemla, 2005, p.391). Furthermore, viewing trade credit as an implicit contract, Chemla predicts "that takeover targets obtain trade credit at more unfavorable terms than other firms before the takeover and that these terms improve after the takeovers (Chemla, 2005, p.391).

Additional evidence is provided in Schmidt (2003). The author shows that in a stakeholder society, such as the German economy, corporate governance fosters long-term cooperation and encourages firm-specific investments by lenders, employees and large shareholders. In this context, insiders are active monitors of management and this may explain why even if an active market for corporate control is absent, management turnover is not

[32] During the period 1970-85, the percentage of trade credit on the gross financing of non financial enterprises has been 18.3% in Japan, and 2.8% and 8.4 in the UK and the US, respectively (see Mayer, 1990, p.312).

lower than in other comparable countries, as shown in Table 2[33]. In any case, also other relevant studies, such as Kaplan (1994), provide evidence that German supervisory boards are effective in removing managers when the firm performs poorly.

Table 2: Market for corporate control and executive turnover (various years)(a)

Countries	Number of hostile bids	Block transfers (b)	Executive turnover
Germany	4	10%	12%
France	n.a.	10%	11%
UK	148	9%	9%
USA	150	7%	n.a.

Source: Schmidt (2003); (a): Germany (89-94); France (89-91); U.K. (89-94), U.S. (80-89)
(b) Block transfers (exceeding 10% of total equity)

As said before, the majority of empirical studies on takeovers are capable to capture *ex-post* shareholders gains and losses, but fail in estimating stakeholders' losses. In a recent paper Bruner (2005) has surveyed the vast empirical literature which has animated the *value creation* and *value destruction* debate on takeovers. What emerges, in our perspective, is that of the 130 studies covering the period 1971-2001 none permits to obtain some estimates of the benefits for stakeholders, for instance in terms of lower prices or job creation.

It must be added that researches on European countries, usually considered more oriented to a stakeholder perspective, have limited themselves to calculate the abnormally high returns reaped by target shareholders, as against the modest gains obtained by bidder shareholders. There is no mention of related stakeholders' premiums (Faccio and Stolin, 2003; Goergen and Renneboog, 2004; Martynova and Renneboog, 2006).

Some interesting, even if indirect, insights on stakeholders returns are however inferred by some contributions such as Croci (2004), that extends the analysis to the long run. In this case the main findings are that raiders do not stay in a company for a period more than, on average, twenty months and many equities are sold within one year from the announcement of the bid. The following table shows more precisely these results:

[33] However, as noticed by the author, the German system helps to create rents that in part may come "from the 'exploitation' of those shareholders who are not insiders, i.e. the small shareholders and possibly also some institutional investors" (Schmidt, 2003, p. 18).

Table 3: Holding period of raiders' purchases: mean, median and holding period distribution in some European countries, 1990-2001

Holding period (years)		Holding period distribution (%)		
Mean	Median	Less than 1 year	Less than 2 years	Less than 3 years
1.71	1.23	43.42%	68.42%	82.89%

Source: Croci (2004), the data refer to UK (1990-2001), Germany (1993-2001), France (1993-2001), Italy (1990-2001), Switzerland (1993-2001).

One of the conclusions reached by Croci (2004, p. 26) is that in any case "raiders are not so prone to interfere with the target management and sometimes limit their action to just costless public statements". The issue concerning the possible inefficiencies of takeovers is still open to debate. The available devices for aligning the interests of stakeholders and those of their agents, such as incentive plans, should also be considered.

2.4 Incentives and labour relationships in a stakeholder model

Reliable measures of stakeholders' welfare are difficult to find, and the problem of providing explicit incentives to pursue the interests of a multiplicity of stakeholders seems to fit well, as noticed in Tirole (2001), with the *multitasks* agency model suggested by Holmstrom and Milgrom (1991). In this model, a well-designed incentive system has to balance the distorsions that may induce effort in one task but indifference and sub-optimal strain in some other occupations.

These considerations gain relevance in a stakeholder perspective, since management may rationalize any action by invoking its impact on the welfare of some stakeholders, even if these actions worsen the welfare of some others. Since this balance is difficult, a *flat* compensation system may be preferable, and in this perspective, "there is some consistency between lenient views in the French, German, and Japanese populations toward the stakeholder society and the low power of the managerial incentive schemes in these countries" (Tirole, 2001, p. 26). The following table shows that in the U.S., i.e. in the more shareholder-oriented system, the CEO's compensation is less flat than in the other countries:[34]

[34] We shall return later on the the specific German case: see footnote 37.

Table 4: **Flat CEO's compensation and stakeholder society: variable remuneration as percentage of total remuneration in some countries**

	Variable CEOs' remuneration component			
Countries	**1996**	**2001**	**2003**	**2005**
France	29%	26%	29%	41%
Germany	12%	36%	51%	52%
Italy	24%	33%	30%	35%
Japan	8%	18%	19%	22%
UK	30%	30%	34%	35%
US	47%	61%	63%	62%

Source**:** Towers Perrin, 2001-2002, 1997, 2005 "Worldwide Remuneration Data"

In any case, even by adopting a flat remuneration system, some critical objections on the feasibility of the stakeholder view remain and the existing literature seems to present two opposite views. As Jensen (2001) writes:

> " Whereas value maximization provides corporate managers with a *single* objective, stakeholder theory directs corporate managers to serve "*many masters*." And, to paraphrase the old adage, when there are many masters, all end up being shortchanged. Without the clarity of mission provided by a *single-valued objective function*, companies embracing stakeholder theory will experience managerial confusion, conflict, inefficiency, and perhaps even competitive failure. And the same fate is likely to be visited on those companies that use the so called. "Balanced Scorecard" approach—the managerial equivalent of stakeholder theory—as a performance measurement system.

Following Jensen, it may be argued that corporate governance arrangements that give 'voice' to employees, as codetermination in Germany, increase agency costs because they dilute the board's power, promote collusion between management and employees and impede the emergence of a dispersed ownership.

On the other hand, the potential strength of a 'broad' view of the firm is advocated. In this alternative perspective "the multiple and hard-to-measure missions of management" (Tirole, 2006, p. 59) are obtained by the same institution of a supervisory board, where owners and employees exert their monitoring function on management. Here, again, the German experience becomes a benchmark model, but in this perspective this experience confirms the success of the 'stakeholder' system of corporate governance, as evaluated in Hall and Soskice (2001a). A success that may be attributed, in a more comprehensive analysis, not only by the *sole* device of a two-tier board, but also by the crucial role played by some *institutional complementarities*, as we will see below.

Let us briefly see how the two different radical views may be supported by simply making a short excursion of some selected studies that are representative of the pro and cons of a stakeholders' view.

The thesis advanced by Jensen (2001) has been proved with different tools, as the sociopolitical analysis proposed by Pistor (1999), the legal perspective advanced by Roe (1999), or the econometric evidence shown in Gorton, Schmidt (2004), just to name some of the few but prominent contributions playing in the arena.

In the sociopolitical perspective, Pistor (1999) suggests that under codetermination labour representatives may be very active actors in *extraordinary* situations, such as those calling for takeover resistance, while exerting a less active role in *day-to day* governance. Employees‘ representatives do not “specialize” in business strategies, but only in workplace and employment matters, notwithstanding the training programs to support their professional competence, as those undertaken in Germany by the National Federation of Labour Unions. In this context where multi-player coalitions are present, the option ‘voice’ remains partly unexploited and a room for managerial failures is left open. “The net beneficiaries are those who ought to be controlled: the company’s management” (Pistor, 1999, p. 192). Furthermore, the voice of labour may be not a single voice, as the mechanism of worker representation reveals conflicts of interests between white and blue collars, who in Germany elect in separate sessions their delegates for the designation of the supervisory board. Without speaking of the contrast with representatives of labour unions who are elected by the same delegates upon proposal of the workers’ organization. In sum, the contrast hidden behind the labour’ s voice raises the cost of collective decision-making, without assuring significant benefits for the absence of a professional competence of this voice.

Analogous skepticism can be found on legal grounds by Roe (1999), an impartial expert who has devoted much of his academic research in evaluating the parallel defects of the shareholder system prevailing in the US (see Roe, 1994). In his contribution of 1999, the emphasis is put on showing how the German Board hinders the functioning of an efficient securities market, thus determining infrequent Initial Public Offering (IPO) and the presence of big blockholders, with the result that German firms remain “semiprivate companies”. One of the main reasons is that diffuse shareholders may be unable to ally and to create a balance of power as a counterweight to the employee block and as a consequence a German securities market does not develop (Roe, 1999, p. 194 -195).

And finally, let us consider the micro econometric evidence, after having noticed that up to recently a rigorous economic analysis has been missing, and there has been little quantitative literature devoted to scrutinize the main effects of codetermination.

Gorton and Schmid, two authors who have devoted a lot of their research to "class struggle" inside the German firms (as the title of one of their works suggest[35]), in a recent study pose two broad questions that focus on the heart of the problem, at least in an economic perspective. First, does high employees' representation on the supervisory board affect the performance of the firm, possibly because labour alters the firm's objective function? Second, are shareholders able to offset these distorsions—away from maximizing shareholder wealth—by taking countermeasures in attempting to offset the voting power of employee representatives?

The authors try to offer some answers to both questions by studying a sample of the 250 largest Germany public companies for the years 1989-1993. What they find is that, when labour and capital have an equal representation on the supervisory board (1/2 seats each), the companies' market to book values are lower in comparison to situations when labour representation is lower (1/3 of seats). And the losses do not reduce over time, but range from 21% in 1989 to 43% in 1992.

A rationale behind these results is that employees wield enough power to obtain private benefits of control, and pursue this strategy by altering managerial remuneration, as confirmed by the weaker link, in cases of more extensive labour participation, between executive managerial compensations and company results. Moreover, employees' representatives aim at maintaining a high staffing level and wield resistance to corporate restructuring. On their part, shareholders try (unsuccessfully) to adopt countermeasures, by linking supervisory board compensation to firm performance and by leveraging up the firm, thus increasing the *cost* and *probability* of bankruptcy failures, but these countermeasures end to be "costly and imperfect."(Gorton, Schmid, 2004, p. 895)

Let us now consider a more optimistic view following the comprehensive approach of Hall and Soskice (2001a) and the several contributes collected in the book they have edited and devoted to analyze the *varieties of capitalism* around the world (Hall and Soskice, 2001b).

In this context it is important to remind the relevance of the *relational* view of the firm, as the quality of the relationships the firm is able to establish is a crucial ingredient of its *dynamic capability* (Teece and Pisano, 1998). From this perspective, as suggested by Hall and Soskice (2001a), a *core distinction* may be traced between two different kinds of relationships that seem to prevail in different systems, the *coordinated* market economies and the *liberal*

[35] See Gorton, Schmid (2000).

market economies. A distinction that shows some significant overlaps, as we shall see, with the difference between a 'broad' and a 'narrow view' of the firm.

In coordinate market economies, as in the German case, extensive relational and incomplete contracting entails more reliance on collaborative relationships and on the exchange of private information. This is coherent with the view that "when complete contracts are too costly or impossible, parties settle for relational agreements that frame their relationship over time" (Morroni, 2006, p.207).

In Germany, this design is mirrored in moderate wage differentials across firms and industries that reduce the propensity of employees to change jobs, thus contributing to a compressed wage structure and to long employment tenure. The employment stability is implemented, at least at a first glance, through the functioning of two relevant labour market institutions. The first one is the industry-level wage bargaining that prevents intra-industry wage differentials and generates low spreads by firm size, thus lowering voluntary separation rates. The second one is the legal institution of codetermination at the level of the supervisory board and works councils. These arrangements, as shown in Freeman and Lazear (1994), enhance the efficiency of the firm by permitting the flows of communications between management and workers, but give *voice* to employees in their demand for lower layoffs and lower labour shedding in case of adverse shocks. In this framework, where an implicit empowerment of labour is provided, the interplay of wage and labour setting rules reveals a crucial factor (FitzRoy and Kraft, 2004). Indeed, as the study of Milgrom and Roberts (1990) has shown in a general context, insiders' involvement may generate lobbying and 'influence' costs with negative side effects that outweight the efficiency gains obtained from better communication. One of these potential drawbacks could be a higher bargaining power over the distribution of the company results, with sub-optimal outcomes. It has been well clarified by Freeman and Lazear (1994).

Assume, following the two authors, that assigning control and information rights to workers' councils increases firm's rent over the level obtained without these organizations, but assume also that these rights affect the division of rents. A clear trade off arises as the firm observes that a higher works council power may enhance productivity and rents (a larger pie), but reduces its own share (a smaller slice). The firm' s choice is a lower sub-optimal level of codetermination since it cannot fully appropriate all the benefits from collaborative labour relations. An escape and solution to the dilemma could be to separate the factors that affect the magnitude of the surplus, from those that have an impact on its division. As underlined by FitzRoy and Kraft: "the designer of co-determination seem to have been aware of these problems, because collective bargaining is formally quite separate from all aspects of codetermination" (FitzRoy, Kraft, 2004, p. 6).

Unlike Germany, in Japan long- term relations are enforced by long term incentives of internal promotion and by returns of seniority that magnify the high commitment of employees to company success and promote lifetime employment, thus encouraging firm-specific investments in human capital. By contrast, in Germany, as is well synthesized in Jackson, Höpner, Kurdelbusch (2005, p. 89), "training takes place within a multi-employer and quasi-public system of occupational training. These skills are portable and related to broad occupations rather than firm specific".

A synthetic representation of the different wage and employment setting rules in coordinated market economies, such as Germany and Japan, with respect to those adopted in liberal market economies (US and UK) is offered by the following table:

Table 5: Comparative features of labour relations in Coordinated Market Economies (CME) and Liberal Market Economies (LME)Stability of employment, wage setting system and wage spread

Countries	Separation rate as % of new hires	Employment tenure (average tenure-years)	Bargaining level (dominant form)	Wage spread (ratio of the ninth over the fifth decile)	Ratio of remuneration of manual workers in Manufacturing to CEO (%)
CME					
Germany	27.2	9.7	sectoral	1.64	8.8
Japan	n.a.	11.3	sectoral	1.73	9.5
LME					
US	65.9	7.4	company	2.22	3.2
UK	42.9	7.8	company	1.99	
Years	1990s	1995	1990s	Early 1990s	2000

Sources: OECD, Employment Outlook (various years); European Commission (2003), Towers Perrin (2005), "Worldwide Remuneration Data"

What complementary institutions are necessary to implement the stakeholders-labour governance? Are only the labour regulation rules sufficient to explain the success of German and Japanese firms? Here the argument of the role played by institutional complementarities suggested by Aoki (1994), reveals to be decisive. This reminds us that the efficiency of one institution increases the efficiency of the others.

Indeed, in coordinated market economies, long term employment relationships call for a "financial system capable of providing capital on terms that are not sensitive to current profitability. It suggests that nations with a particular type of coordination in one sphere of the economy should develop complementary practices in other spheres as well" (Hall, Soskice, 2001a, p. 18).

Also, the option *voice,* which sustains long term relationships, is related to concentrated ownership which permits to overcome the free-riding problem of dispersed ownership, since large investors are able and motivated to exercise control by obtaining significant gains by their monitoring activity. In addition inter-firm relations are relevant and are achieved by cross-shareholdings in Germany, where more than 40% of total shares of companies are owned by other non financial enterprises (see Table 6), or through business networks, built on keiretsu organizations, in Japan.

Moreover, bank monitoring may be a relevant element in *relational financing*. For instance, in Germany, banks and client firms maintain long term relationships since banks have access to information on firms' financial conditions (Edwards and Fischer, 1994). Thus they are able to distinguish between good and bad projects and may renegotiate with failing, but efficient, firms in difficulties, thus avoiding their premature liquidations and favoring their restructuring.

Table 6: Comparative features of corporate governance in the 1990s in Coordinated Market Economies (CME) and Liberal Market Economies (LME)
Concentration of ownership and of voting rights, role of financial institutions, inter-firm relations

Countries	Concentrated ownership (average percentage of shares owned by the first 5 largest owners) (a)	Largest voting block (as a percentage of voting shares) (median) (b)	Financial institutions as principals (percentage of total outstanding shares) (a)	Inter firm relations (percentage of common stocks owned by other non financial enterprises) (a)
Years		1992-1996		1994-2001
CME				
Germany	41.5	57.0	33.0	42
Japan	33.1	n.a.	38.5	22
LME				
US	25.4	5.4 - 8.6 (*)	2.2	0
UK	20.9	9.9	0.7	1

Sources: (a), Prowse (1995); (b) Barca and Becht (2001, table 1.1) data for non financial enterprises, (c); OECD (2003). (*) the figures refer, respectively, to NYSE and NASDAQ

Summing up, the coexistence of concentrated ownership, long term oriented strategies, bank financing, inter-firm relations, industry-level wage bargaining, small wage dispersions are all significant aspects of a *variety of capitalism*, where relevant forces are present capable to implement long term relationships and the interests of a group of stakeholders. Furthermore, these coordinated economies are more oriented toward investing "in *specific* and *co-specific* assets - i.e. assets that cannot readily be turned to another purpose and assets whose returns depend heavily on the active cooperation of others", as Hall and Soskice suggest (2001a, p.17). It is not by chance, as documented by the European Patent Office, that German firms specialize in those sectors (mechanical engineering, product handling, transport, machine tools) characterized by incremental innovation, while lagging behind the US in fields (biotechnology, semiconductors, telecommunications), where innovation are more radical and represent strong discontinuities.

By contrast, liberal market economies, featuring short-term relationship, tend to invest more extensively in *switchable* assets (i.e. assets whose value can be realized if diverted to other purposes). In this context, institutional complementarities work in the opposite direction. In these economies, corporate governance arrangements permit to investors who seek an immediate assurance of return of their assets to freely exert the option *exit*. These features are complementary to analogous market channels to obtain finance and are parallel to market relations and arm's-lenght exchanges of labour services. In these economies, the distinctive features of labour relationships are wage patterns linked to labour market conditions, decentralized company level bargaining, and finally no restrictions on labour adjustment. Moreover, market failures, as moral hazard and selection adverse problems, are solved by *explicit* incentives such as pay-performance systems or employee share ownership schemes that are introduced to enhance wage flexibility.

A parallel interpretation of these findings is that remuneration schemes, as tools for corporate governance, emerge as an *indirect* control device under conditions of imperfect observability (Holmstrom, 1979), and therefore, when other *direct* control measures are absent.

This proposition fits well with observed phenomena, as shown in the following table:

Table 7: Remuneration and incidence of incentive systems in Coordinated Market Economies (CME) and Liberal Market Economies (LME)

Countries	Remuneration of CEOs (US=100) 2005	Percentage of firms that offer long term incentives to CEOs 2005			Percentage of firms that use Profit sharing (PS) and ESOP 1990s
CME		Stock options	Restricted stocks	Bonus shares plans	
Germany	47.1	40	5	10	PS. 13% ESOP 4%
Japan	44.2	35	0	0	PS. 13% ESOP 3%
LME					
UK	54.4	80	0	60	PS. 40% ESOP 23%
US	100	85	35	35	PS. 20% ESOP 7.7% *

Sources: Towers Perrin, 2005, "Worldwide Remuneration Data" and Equity Report, OECD (2003); Poutsma (2001) and Kruse (2002); * percentage of private sector employees participating in ESOP schemes

The different remuneration *levels* among countries confirm that managerial incentives play a crucial role especially in Anglo-Saxon systems, since direct monitoring and incentive payment systems emerge as close substitutes. Furthermore, the *composition* of incentive schemes, as documented in the last Equity Report by Towers Perrin, shows that the US system tends to rely more on performance-based rewards and on long-term incentive plans, as stock options or restricted stock, which represent an *explicit incentive* to pursue firms' successful strategies. These payment systems, as shown in the recent literature on executive compensation summarized in Damiani (2006), have also been an essential *selection* and *retention* tool in managerial labour markets, a very strategic tool in a context where short-term relations tend to prevail (Ittner, Lambert, Larcker, 2003; Oyer e Schaefer, 2005). These considerations may explain why their relevance is still prominent today, even after the scandal and managerial failures that have triggered the corporate governance reform undertaken in 2002 (Sarbanes Oxley Act). Moreover, their diffusion is accompanied by employee participation in profit and ownership, as well documented in Poutsma (2001) and Kruse (2002), as shown in Table 7.

However, if top executives exert their influence on compensation committees and adopt rents seeking behavior, managerial rewards becomes not a solution, but a manifestation of agency problems as shown in Bebchuk, Fried (2003). In this context, all the other subordinate workers may share rent seeking behavior and a pervasive inefficient compensation structure tends to prevail.

This has serious negative implications, as suggested by Baker, Jensen e Murphy (1988):

"The effect of structuring CEO contracts that are independent of performance is likely to cascade down the hierarchy-each successive layer has fewer incentives to structure effective contracts than the prior layer. The absence on incentives is pervasive, and it's not surprising that large organizations typically evolve into bureaucracies" (Baker, Jensen e Murphy , 1988, p. 614).

In Germany and Japan, where management control is easier and less expensive and lifetime commitment is higher, executive rewards are lower. Moreover, in these countries the lower *level* of managerial salaries is accompanied by a *weaker link* to company performance (table 4) and the wide diffusion of stock options and bonus shares paid not only to CEOs but also offered to all 'agents' is absent. Furthermore, the analysis of the German 100 largest companies shows a clear positive correlation between shareholder value orientation of these enterprises and incentive orientation of their payment schemes for non executive employees (Jackson, Höpner, Kurdelbusch, 2006, pp. 106-112). This wide diffusion is, on the other hand, very often recorded in the US and the UK, where Profit Sharing Schemes and ESOP Plans[36] are paid to a broader base of dependent employees (Table 7).

The previous analysis confirms that the diffusion of forms of financial employees' participation has not been a part of a "package of participation" in control rights. This sort of bifurcation between *payoff* and *control* rights has been well documented by the vast participation literature (Uvalic, 1991; Poutsma, 2001; Pérotin, Robinson 2003; Uvalic, 2006). As stressed in Uvalic (2006), "although traditionally the main arguments in favor of financial participation were motivated by objectives such as greater equality in the distribution of income and wealth, and improving relations between workers and capitalists, today these schemes are considered as part of a new culture of industrial relations based on innovative managerial strategies and more flexible remuneration policies, which should ultimately result in increased enterprise efficiency" (Uvalic, 2006, p. 50). The majority of studies in this field have shown how the wide diffusion of various forms of financial employee participation has performed with the main aim to enhance wage flexibility, to achieve productivity gains and to implement a risk-sharing device. This explain why they have found a natural space in liberal market economies, more than in coordinated market economies. On the other hand, there are not conclusive results on the positive impact of a larger involvement of employees in

[36] As clarified in Uvalic (1991, p.10) ESOPs "… involve a bank (or other lender) lending money to an employee benefit trust, which acquires company stock that is allocated by periodic payments to each employee's ESOP account".

decisional processes in terms of productivity gains, and only some studies (see Conte, Svejnar, 1990) are capable to confirm the positive interactions between the various forms of participation. In any case, the debate on advantages and disadvantages of employee financial participation, as overviewed in Uvalic (2006), has mainly concerned issues such as workers' incentives, wage moderation, promotion of firm-specific human capital investments--via long-term labour contracts, lower intrafirm conflicts--less inequalities, risk sharing properties. But it must be admitted that this is a clear 'shareholder' perspective, one in which theorists and econometricians have the hard task to prove that "wage premiums pay by themselves".

On the contrary, in a 'stakeholder' view one of the main claims should be that "if employees have no input into decision, they are exposed to moral hazard on the part of managers, who may make decisions that affect pay and or wealth negatively. The problem is potentially more severe with employee share ownership than with simple profit sharing…" (Pérotin, Robinson, 2003, p.11)

This is the preferential attitude declared, in 2004, by the OECD Principles of Corporate Governance where it is said that "the corporate governance framework should permit performance enhancing mechanisms for stakeholder participation " (OECD, 2004, section IIIc, p.)

To what extent this participation has been reached may be, at least partly, assessed by the diffusion of the various forms of participation all over the countries, as well documented in the 2003 OECD survey, one of the few that devotes a section to describe the diffusion of stakeholder protections.

Table 8: Control rights and payoff rights of employees

Countries	**Employees appoint some board members** *(a)*	**Mandated Works Councils Statutory threshold** *(b)*	**Decision making power** (c)	**Diffusion of financial participation schemes** *Percentages of private and public companies that adopt Employee Share Ownership Plans (ESOP)* and Profit Sharing (PS)
Austria	Yes	5 employees*	Personal matters	ESOP: small number of ESOP PS: n.a.
Belgium	No	100 employees	Work regulations, recruitment, dismissals, welfare and holidays	ESOP: Selective application in specific companies PS: mainly by multinational firms
Denmark	Yes	35 employees	Working conditions, personnel policy and training	ESOP: 6% PS: 10%
Finland	No	30 employees	-	ESOP: n.a PS: small number of companies
France	No	50 employees	Management of all company welfare schemes	ESOP: 7% PS:57%
Germany	Yes	5 employees*	Social welfare, personnel policies and economic affairs	ESOP: 4% PS: 13%
Ireland	No	No	n.a.	ESOP:4 % PS: 8%
Italy	No	15 employees	-	ESOP:3 % PS: 4%
Japan	No	No	n.a.	ESOP:3 % PS: 13%
Netherlands	Yes	50 employees	Rules concerning employees benefits, working hours, holidays, health and security, recruitment, dismissals and training	ESOP: 3% PS: 13%
Spain	No	50 employees	Collective agreements	ESOP: 10% PS: 8%
Sweden	Yes	No	Cn.a.	ESOP: 2% PS: 20%
UK	No	No	n.a.	ESOP: 23% PS: 40%
US	No	No	n.a.	ESOP: 7,7%* PS: 20%

Sources:(a), (b), (c): OECD (2003, pp. 47-50); (d): EPOC Survey (1996), Poutsma (2001, p. 57) Kruse (2002, p. 67); * percentage of private sector employees participating in ESOP schemes.

2.5 Conclusions

In shaping governance and labour management in a stakeholder society, a whole set of institutional factors, much more than the sole codetermination arrangements, are shown to be crucial.

In this context the role of institutional linkages and complementarities may offer a fruitful line of research, as this perspective leaves a natural space to reconsider the full range of opportunities left to labour coalitions with the other two actors, capital and management. After all, as noticed by Pagano and Volpin (2005, p.841) "*Labor economists* view industrial relations as being shaped by the conflict between workers and management. *Financial economists* view corporate governance as the outcome of the diverging interest of shareholders and management. Actually, these two conflicts are present simultaneously and interact".

Indeed as seen in the previous sections, the comparison of the various forms of capitalism reveals the potential drawbacks when workers are natural allies of managers and become accomplices of their misconduct. In this scenario, the traditional conflict between capital and labour may be replaced by a new conflict between *strong* insiders (management, employees, blockholders) and *weak* outsiders (small shareholders). In this scenario, the 'broad view' of the firm does not represent a remedy to externalities and sub-optimal results, but on the contrary it may be at the origin of new failures. In any case, as noticed by Coffee (2005), in the last decade, the different economies, the coordinated market economies as well as the liberal market economies, have witnessed different forms of failures and scandals. However, they have shared a common feature represented by a bad performing function of their respective governance gatekeepers. Enron and Parmalat, from their respective sides, offer dramatic but instructive lessons.

In this scenario, where the eventual convergence[37] toward a unique system of corporate governance may represent the menace of a convergence toward a uniform kind of failures, labour may assume a potential role as a *natural guardian* of firm accountability. Control by empowered employee representatives could contribute to mitigate opportunistic behavior and rent seeking by managers and to reduce private benefits of control accruing to blockholders.

---

[37] The 'convergence' issue is still controversial and open to debate; for instance, for the German case Jackson, Höpner, Kurdelbusch (2004) stress that "a more marketized role of capital has led to changes toward more marketized employment relations in Germany". However, the author stress that "the diffusion of shareholder-value has not undermined the

After all, if we conceptualize the firm as a set of *multilateral* contracts over *time*, and admit that employees sign implicit and explicit agreements with the other parts, their rights to bargain over the distributive effects of these agreements must be acknowledged and the condition of a *fair* contract is required. As Freeman suggests in his “stakeholder interpretation’ of corporate governance, one device for obtaining fairness is the Rawlsian ‘veil of ignorance’:

> “Our common sense notion of fairness is illustrated by the problem of dividing a cake into two pieces for two individuals. The ‘’fair’ solution is for one individual to cut the cake and choose last, or put another way, to cut the cake without knowing which piece he will receive in the end… Interpreting fairness as taking place behind the veil of ignorance is consistent with the spirit of transaction cost economics, since it must take into account both ex post and ex ante perspectives. It would be irrational for stakeholders to give up the ability to participate in monitoring the actual effects of the firm on them… ” (Freeman, 1990, p. 357).

---

core institutions of German industrial relations, namely codetermination and collective bargaining” (p. 40).

References

Aglietta, M., Rebérioux, A. (2005), *Corporate Governance Adrift: A Critique of Shareholder Valu,*. Cheltenham, Elgar.

Allen F., Gale D. (2000), *Comparing Financial Systems*, Cambridge, MIT Press.

Andrade G., Mitchell M., Stafford E. (2001), "New Evidence and Perspectives on Mergers", *Journal of Economic Perspectives*, vol. 15, no. 2, pp. 103-120.

Aoki M. (1994), "The Japanese Firm as a System of Attributes: a Survey and Research Agenda", in M. Aoki, Dore R. (eds.), *The Japanese Firm: Sources of Competitive Strength*", Oxford, Clarendon Press, pp. 11 - 40.

Aoki M. (2004), "A Comparative Institutional Analytic Approach to Corporate Governance", in: Grandori A. (ed.), *Corporate Governance and Firm Organization Microfoundations and Structural Forms,* Oxford, Oxford University Press, pp. 30-44.

Baker G.P., Jensen M.C., Murphy K.J. (1988), "Compensation and Incentives: Practice versus Theory", *Journal of Finance*, vol. 43, no. 3, pp. 593-616.

Barca F., Becht M. (2001), *The Control of Corporate Europe,* Oxford, Oxford University Press.

Baumol W.J. (1959), *Business Behavior, Value and Growth*, New York, Macmillan.

Bebchuk L. A., Fried J.M. (2003), "Executive Compensation as an Agency Problem", *Journal of Economic Perspectives*, vol.17, no. 3, pp. 71-92.

Becht M., Bolton P., Roell A.A. (2003), "Corporate Governance and Control", in Costantinides G., Harris. M. Stulz R. (eds), *Handbook of the Economics of Finance*, Amsterdam, North Holland.

Becht, M. (1997) "Strong Blockholders, Weak Owners and the Need for European Mandatory Disclosure: European Corporate Governance Network Executive Report", http://www.ecgi.org/research/control_europe/documents/eu.pdf.

Berle, A. A., Means G. C., (1932), *The Modern Corporation and Private Property,* New York, McMillan, 1934 (originally published in 1932).

Bertrand M., Mullainathan S. (1998), "Executive Compensation and Incentives: The Impact of Takeover Legislation", *NBER Working Paper* , n. 6830.

Bertrand M., Mullainathan S. (2003), "Enjoying a Quite life", *Journal of Political Economy*, vol. 111, no. 5, pp. 1043-1075.

Blair M. (1995), *Ownership and Control. Rethinking Corporate Governance for the Twenty-First Century*, Washington, The Brookings Institution.

Blair M., Roe M. J. (1999) (eds.), *Employees and Corporate Governance*, Washington, D.C., The Brookings Institution.

Boitani A., Damiani M. (2003), *Una Nuova Economia Keynesiana*, Bologna, Il Mulino.

Bruner R. F. (2005), *Does M&A Pay?, A Survey of Evidence for the Decision-Maker*, Batten Institute, mimeo.

Bulow J., Shoven J. B. (2005), “Accounting for Stock Options”, *Journal of Economic Perspectives*, vol. 19, no.4, pp.115-134.

Chemla G. (2005), “Hold-up, Stakeholders and Takeover Threats”, *Journal of Financial Intermediation*, vol. 14, pp. 376 – 397.

Chilosi A. (2006), “Aglietta, M., and Reberioux, A.: *Corporate Governance Adrift. A Critique of Shareholder Value*”, Book Review, *Journal of Economics,* vol. 88, no. 3, pp. 307-311.

Coffee J.C. (2005), “A Theory of Corporate Scandals: why the U.S. and Europe Differ”, *Oxford Review of Economic Policy*, vol. 21, no. 2, pp. 198- 211.

Conte M., Svejnar J. (1990), “The Performance Effects of Employee Ownership Plans”, in Blinder A.S., (ed.), *Paying for Productivity A look at the Evidence,* The Brookings Institution, Washington D.C.

Croci E. (2004), “The Long Run Evidence about Corporate Raiders in Europe”, EFMA 2004 Basel Meetings Paper. Available at SSRN: http://ssrn.com/abstract=499265

Damiani M. (2006)*, Impresa e Corporate Governance*, Roma, Carocci.

Denis D., McConnell J. (2003), “International Corporate Governance”, *ECGI Working Paper*, no. 5/2003. Available at SSRN: http://ssrn.com/abstract=320121.

Dick A., Zingales L. (2004), “Private Benefits of Control: An International Comparison”, *Journal of Finance*, vol. 59, no. 2, pp. 537-600.

Edwards J., Fischer K. (1994), *Banks, Finance and Investment in Germany*, Cambridge, Cambridge University Press.

European Commission (2003), *Employment in Europe, 2003- Recent Trends and Prospects*, Directorate General for Employment and Social Affairs.

Faccio M., Lang L.H.P. (2002), “The Ultimate Ownership of Western European Corporations”, *Journal of Financial Economics*, vol. 65, no. 3, pp. 365-395.

Faccio, M., Stolin, D. (2003), “Expropriation vs. Proportional Sharing in Corporate Acquisitions”, *Journal of Business,* vol. 79, pp. 1413-1444.

Fitzoy F.R., Kraft K. (2004), “Co-determination, Efficiency and Productivity”, *IZA Discussion Paper*, no. 1442.

Freeman R. B., Lazear E.P. (1994), "An Economic Analysis of Work Councils", *NBER Working Paper*, no. 4918.

Freeman R.B. (1990), " Corporate Governance: a Stakeholder Interpretation", *Journal of Behavioral Economics*, vol. 19, no. 4, pp. 337 - 360.

Freeman R. B., Lazear E. P. (1994), "An Economic Analysis of Works Councils", NBER Working Paper No. 4918, November.

Goergen, M., Renneboog, L. (2004) 'Shareholder Wealth Effects of European Domestic and Cross-Border Takeover Bids', *European Financial Management*, vol. 10, pp.9-45.

Gorton G., Schmid F. (2000), "Class Struggle Inside the Firm: A Study of German Codetermination", *NBER Working Paper*, no. 7945.

Gorton G., Schmid F. (2004), "Capital, Labor and the Firm: A Study of German Codetermination", *Journal of the European Economic Association*, vol. 2, no. 5, pp. 863- 905.

Gospel H., Pendleton A. (eds.) (2006), *Corporate Governance and Labour Management*, Oxford, Oxford University Press.

Grossman, S. J., Hart O. D. (1980), "Takeover Bids, The Free-Rider Problem, and the Theory of the Corporation" *The Bell Journal of Economics*, Vol. 11, No. 1, pp. 42-64.

Gugler K. (2001), *Corporate Governance and Economic Performance*, Oxford, Oxford University Press.

Hall B.J., Murphy K.J. (2002), "Stock Options for Undiversified Executives", *Journal of Accounting and Economics*, vol. 33, no.1, pp.3-42

Hall P.A., Soskice D. (2001a), "Introduction", in Hall P.A., Soskice D. (eds.) (2001b), pp. 1-68.

Hall P.A., Soskice D. (2001b), *Varieties of Capitalism*, Oxford, Oxford University Press.

Hellwig M. (2000), "On the Economics and Politics of Corporate Finance and Corporate Control", in Vives X. (ed.), *Corporate Governance*, Cambridge, Cambridge University Press.

Hernández-López E. A. (2003), "Bag Wars and Bank Wars, the Gucci and Banque National de Paris Hostile Bids: European Corporate Culture Responds to Active Shareholders", *Fordham Journal of Corporate & Financial Law*, Vol. 9, No. 1, pp. 127-190. Available at SSRN: http://ssrn.com/abstract=809985

Holmstrom B. (1979), "Moral Hazard and Observability", *Bell Journal of Economics*, vol. 10, no. 1, pp. 74-91.

Holmstrom B., Milgrom P. (1991), "Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design", *Journal of Law, Economics, and Organization*, vol. 7, no. 1, pp. 24-52.

Holmstrom B., Milgrom P. (1994), “The Firm as an Incentive System”, *American Economic Review*, vol. 84, no. 4, pp. 972-991.

Ittner C.D., Lambert R.A., Larcker D.F. (2003), The Structure and Performance of Equity Grants to Employees of the New Economy Firms, *Journal of Accounting and Economics*, vol. 34, no. 1-3, pp. 89-127.

Jackson G., Höpner M., Kurdelbusch A. (2004), “ Corporate Governance and Employees in Germany: Changing Linkages, Complementarities, and Tensions”, RIETI Discussion Paper Series 04-E-008, http://www.rieti.go.jp/jp/publications/dp/04e008.pdf .

Jensen M. C. (2001), “Value Maximization, Stakeholder Theory, And The Corporate Objective Function”, *Bank of America Journal of Applied Corporate Finance*, vol. 14, no. 3, pp. 8- 21.

Jensen M.C. (1986), “Agency Costs of Free Cash Flow, Corporate Finance and Takeovers”, *American Economic Review*, vol. 76, no. 2, pp. 323-329.

Jensen M.C., Ruback R. (1983), “The Market for Corporate Control: The Scientific Evidence”, *Journal of Financial Economics*, vol. 11, no. 1, pp. 5-50.

Kaplan S. (1994), “Top Executives, Turnover and Firm Performance in Germany”, *Journal of Law, Economics and Organization*, vol. 10, no. 1, pp. 142-159.

Kreps D.M. (1984), “Corporate Culture and Economic Theory”, Stanford University Graduate School of Business, mimeo.

Krugman P. (2002), “For Richer”, *NYT Magazine*, October 20, http://faculty.pnc.edu/arw/gbg344/For%20Richer.htm.

Kruse D. (2002), “Research Evidence on the Prevalence and Effects of Employee Ownership”, *The Journal of Employee Ownership Law and Finance*, vol. 14, no. 4, pp. 65-90.

La Porta R., Lopez-de Silanes F. Shleifer A., Vishny R. (1998), “Law and Finance”, *Journal of Political Economy*, vol. 106, no. 6, pp. 1113-1155.

Levine, D. I, Tyson L.D.’A. (1990), “Participation, Productivity, and the Firm’s Environment”, in Blinder A, (ed.), *Paying for Productivity*, The Brookings Institution.

Macaulay S. (1963), “Non-Contractual Relations in Business: A Preliminary Study”, *American Sociological Review*, vol. 28, pp. 55-67.

Maher M., Andersson T. (1999), *Corporate Governance: Effects on Firm Performance and Economic Growth*, OCSE, Paris.

Manne, H.G. (1965) ‘Mergers and the market for corporate control’, *Journal of Political Economy*, vol. 73, 110-120.

Marris R. (1964), *The Economic Theory of Managerial Capitalism*, London, Macmillan.

Martynova M., Renneboog L. (2006), "Mergers and acquisitions in Europe", Discussion Paper No. 6, Tilburg University.

Mayer C. (1990), "Financial Systems, Corporate Finance, and Economic Development", in Hubbard R. G. (a cura di), *Asymmetric Information, Corporate Finance, and Investment*, Chicago, University of Chicago Press.

Milgrom P., Roberts J. (1990), "Bargaining Cost, Influence Costs, and the Organization of Economic Activity," in Alt J., Shepsle K. (eds.), *Perspectives on Positive Political Economy*, Cambridge, Cambridge University Press.

Mitchell, M.L., Mulherin, H.J. (1996) 'The impact of industry shocks on takeover and restructuring activity', *Journal of Financial Economics*, vol. 41, pp. 193-229.

Morroni M. (2006), *Knowledge, Scale and Transaction in the Theory of the Firm*, Cambridge, Cambridge University Press.

Moxter A. (2001), "Karl Hax: His Work and Life as We See It Today." *Schmalenbach Business Review*, Vol. 53, October, pp. 250-262.

OECD (2003), *Survey of Corporate Governance Developments in OECD Countries,* Paris.

OECD (2004), *Principles of Corporate Governance,* Paris.

Oyer P., Schaefer S. (2005), "Why Do Some Firms Give Stock Options to All Employees? An Empirical Examination of Alternative Theories", *Journal of Financial Economics*, vol. 76, no.1, pp. 99-133.

Pagano M., Volpin P. F. (2005), "Managers, Workers and Corporate Control", *Journal of Finance*, vol. 60, no. 2, pp. 841-868.

Pérotin V., Robinson A. (2003*), Employee Participation in Profit and Ownership: a Review of the Issues and Evidence*, Working paper, Social Affairs Series, SOCI 109 EN, Luxembourg Parliament, Directorate- General for Research.
http://www.efesonline.org/LIBRARY/Employee%20Participation%20in%20Profit%20and%20Ownership%20P%E9rotin%2003.pdf

Pistor K. (1999), " Codetermination: a Sociopolitical Model with Governance Externalities", in Blair M., Roe M. J. (1999) (eds.), pp. 163 – 193.

Poutsma E. (2001), *Recent Trends in Employee Financial Participation in the European Union*, Dublin, European Foundation for the Improvement of Living and Working Conditions.
http://ec.europa.eu/employment_social/labour_law/docs/financialpartdublinreport_en.pdf

Prowse S. (1995), "Corporate Governance in an International Perspective: A Survey of Corporate Control Mechanisms Among Large Firms in the U.S., U.K., Japan and Germany", *Financial Markets, Institutions and Instruments*, vol. 4, no. 1, pp. 1- 63.

Rajan R.G., Zingales L. (1995), "Is There an Optimal Capital Structure? Some Evidence from International Data", *Journal of Finance*, vol.50, no. 5, pp. 1421 – 1460.

Rajan R.G., Zingales L. (1998), “Power in a Theory of the Firm”, *Quarterly Journal of Economics*, vol. 113, no. 2, pp. 387- 432.

Rappaport, A. (1986), *Creating Shareholder Value: The New Standard for Business Performance,* New York, Free Press.

Roe M.J. (1994), *Strong Managers, Weak Owners: the Political Roots of American Corporate Finance*, Princeton, Princeton University Press.

Roe M.J. (1999), “Codetermination and German Securities Markets”, in Blair M., Roe M. J. (eds.), pp. 194 – 205.

Rossi S., Volpin P. F. (2004) “Cross-Country Determinants of Mergers and Acquisitions”, *Journal of Financial Economics*, vol. 74, pp. 277-304.

Schmalenbach E. (1948), *Dynamische Bilanz*, 10th ed. Bremen, Industrie und Handelsvertrag Walter Dorn.

Schmidt R.H. (2003), “Corporate Governance in Germany: an Economic Perspective”, Center of Financial Studies, *CFS Working Paper*, no. 36.

Sharpe W. (1964), “Capital Asset Prices: a Theory of Market Equilibrium Under Conditions of Risk,” *Journal of Finance*, vol. XIX, n. 3, pp. 425-442.

Shiller R. (1987), “Investor Behavior in the 1987-10 Stock Market Crash: Survey Evidence”, Cowles Foundation, Yale University, *Cowles Foundation Discussion Paper*.

Shiller R. (2003), “From Efficient Markets Theory to Behavioral Finance”, *Journal of Economic Perspectives*, vol. 17, n. 1, pp. 83-104.

Shleifer A., Summers L.H., (1987), “Breach of Trust in Hostile Takeovers”, *NBER Working Paper*, no. W2342. Available at SSRN: http://ssrn.com/abstract=227274

Shleifer A., Vishny R. (1989), “Management Entrenchment: the Case of Manager Specific Investments”, *Journal of Financial Economics*, vol. 25, no. 1, pp. 123-139.

Shleifer A., Vishny R. (1997), "A Survey of Corporate Governance," *Journal of Finance*, vol. 52, no. 2, pp. 737-783.

Shleifer, A., Vishny R. (2003), “Stock Market Driven Acquisitions,” *Journal of Financial Economics*, vol. 70, pp. 295-311.

Smith, A. (1776), *An Inquiry into the Nature and Causes of the Wealth of Nations*, London, Methuen. Ed. Edwin Cannan, 1904 (first edition 1776). Available online from http://www.econlib.org/library/Smith/smWN1.html.

Stulz P. (1988), “Managerial Control of Voting Rights: Financing Policies and the Market for Corporate Control”, *Journal of Financial Economics*, vol. 20, single issue, pp. 25-54.

Teece D., Pisano G. (1998), "The Dynamic Capabilities of Firms", in Dosi G., Teece D., Chytry J., (eds.), *Technology, Organization and Competitiveness*, Oxford, Oxford University Press, pp. 193 - 212.

Tirole J. (2001), "Corporate Governance", *Econometrica*, vol. 69, no. 1, pp. 1- 35.

Tirole J. (2006), *The Theory of Corporate Finance*, Princeton, Princeton University Press.

Uvalic, M. (1991), *The Pepper Report: Promotion of Employee Participation in Profits and Enterprise Results in the Member States of the European Community*, Social Europe Supplement, no.3/91, Luxembourg Office for Official Publications of the European Communities.

Uvalic, M. (2006), "Employee Ownership - Western Lessons for the Eastern New EU Member States", in *The Pepper III Report: Promotion of Employee Participation in Profits and Enterprise Results in the New Member and Candidate Countries of the European Union,* Inter-University Center Split/Berlin, Institute for Eastern European Studies, Free University of Berlin, pp. 46- 68.

Veblen, T. (1904), *The Theory of Business Enterprise*, New York, Charles Scribner's Sons. Available as image of the original text at Google Scholar, or as Internet text at: http://www.worldebooklibrary.com/eBooks/WorldeBookLibrary.com/veblen2.htm

Williamson O. (1985), *The Economic Institutions of Capitalism*, New York, The Free Press.