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Law and Corporate Governance

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<https://escholarship.org/uc/item/6nt8622j>

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### Publication Date

2005-03-01

Law and Corporate Governance\*

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March 2005

\* This paper was prepared for the Annual Review of Law and Social Science. We would like to thank Robert Gordon for comments on an earlier draft.

## Introduction

One of the great intellectual divides in modern social science is the gap between economics and sociology. Classically, economists have seen the rise of modern society as the reduction of the role of governments and the influence of rent seeking actors and their replacement with calculating individuals who sought profits by producing for markets (Smith 1904). By being forced to compete with others, the “invisible hand of the market” pushed producers to create the efficient allocation of societal resources and of course, they became the source of the “wealth of nations.” While classical sociology saw the rise of modern society as deeply connected with markets, it also maintained that social elements like law, norms, religion, social classes, and politics played crucial roles in the development of firms and markets (Durkheim 1997, Marx 1977, Weber 1978; 2001). Both Marx and Weber foresaw many of the problems markets would create, such as the economic instability caused by ruinous competition, the attempts by producers to obtain monopolies and enlist the state on their behalf in these efforts, and the possibility that governments would be rent seekers in their own right.

More recently, economic sociology has pushed forward the view that action in markets is less about anonymous firms competing over the price of goods and more about firms creating social structures for particular markets (Fligstein 2001, Granovetter 1985, White 2002). For economic sociology, the degree to which these social structures were

efficient from a neoclassical perspective is an empirical question. Indeed, much of sociology has been agnostic on the question of whether social institutions (including markets) are efficient. Sociologists have argued that under some conditions one set of arrangements might be more profitable than another, but they are equally prepared to believe that social institutions and markets are artifacts of historical accidents whereby one social group has benefited over others and this has a complex link to optimal economic outcomes (see Granovetter 1985 for an argument to this effect).

The gap between sociology and economics has narrowed significantly in the past 15 years. For example, Douglass North, a Nobel Prize winning economist, has argued that legal, political, and social institutions played a fundamental role in the rise of the West (North 1981; 1990). A whole branch of historical and institutional economics has begun to explore the role of social factors in the relative performance of the developed and less developed societies (Acemoglu et al. 2001, Amsden 2001, Djankov et al. 2003, Greif 1994, La Porta et al. 1998; 1999a, b; 2002a, Rodrik 2003, Shleifer & Vishny 1993; 1994a, b; 1997, Wade 1990). Bodies of literature in sociology, law, and political science have always considered social and political factors as fundamental to firms and economic growth. Scholars have attributed differences in capitalist systems to varying degrees and types of state interventions into the economy, legal systems, structures of capitalist enterprises, and processes of economic growth (Albert 1993, Cioffi 2000, Coffee 2001a, b, Crouch & Streeck 1997, Evans 1995, Fligstein 1990, Hall & Soskice 2001, Mahoney 2001, Roe 1994; 2003, Streeck 1992). Efforts to understand these links have grown even more intense with the collapse of communism, the continued bad economic times in Africa, and the rapid economic growth of the Asian economies (Evans 1995, Eyal et al.

1998, Guthrie 1999, Nee 1992, Radaev 2002, Stark 1996). Economists, sociologists, legal scholars, and political scientists have converged on an old, deep question: how do social and legal arrangements affect firms, markets, and economic growth?

The purpose of this paper is to review the recent literature that surrounds the comparative and historical study of law and corporate governance. We accept Cioffi's definition of corporate governance as a "nexus of institutions defined by company law, financial market regulation, and labor law (2000: 574)." Our review begins by elaborating upon this definition. Then, we consider how the problem of efficiency was introduced into discussions of law and corporate governance by agency theory. We suggest that much of the current literature has offered both a theoretical and an empirical critique of the agency theory perspective on the evolution of systems of corporate governance. The literature now agrees that there is variation in systems of corporate governance across societies and most of this difference reflects national political, social, and cultural trajectories that have created and continuously shaped the laws that define corporate governance. In spite of these noneconomic processes dominating the structuring of law and markets, scholars have continued to wonder if certain systems of corporate governance might even accidentally prove to be more efficient at producing long term economic growth. This leads us to consider the literature on how political and legal institutions affect the economic performance of societies. We end with some observations about what we do and what we do not know in this contentious field.

#### Definition of Corporate Governance

It is useful to try and propose a general framework to organize the literature. The first step is to define the three relevant types of laws for understanding the comparative structuring of corporations. First, company law defines the legal vehicles by which property rights are organized (Hansmann & Kraakman 2000). It defines the legal standing of public and privately held corporations. It also specifies the legal liability of owners. In the case of publicly held corporations, it helps define the relationships among owners, boards of directors, managers, and workers. The main variable that is of interest in the literature is the degree to which there is a separation of ownership from control in publicly held corporations. One main way to index this separation is the degree to which shareholding of firms is widespread or concentrated (either in banks, other financial institutions, or families).

Second, financial market regulation refers to how firms obtain capital for their operations and in doing so specifies their relationships to banks, other financial institutions, and public equity and debt markets. All firms need to raise capital to fund their operations. Owners traditionally have supplied their own funds to do this. But, as the scale of enterprise has grown in the past 150 years, firms have needed to borrow larger sums of money. Historically, banks and private individuals were the main source of these funds. Since 1950, firms (particularly in the U.S.) have increasingly turned to the public markets to raise money. The equity markets allow firms to sell additional stock in the firm, while the bond markets allow firms to borrow money and issue bonds that will be repaid eventually. Financial market regulations refer to the laws that govern all of these transactions, both private and public. In the case of the sale of equity and debt, they

also force firms to disclose information in order for potential lenders and investors to understand the financial situation of the firm.

Third, labor law defines how labor contracts will operate in a particular society. Such laws include the rights of labor to organize, the conditions under which labor is hired and fired, and how and to what degree workers participate in corporate governance. These issues are paramount for corporate governance because they greatly affect the structure of the firm and the ways in which decisions get made on the allocation of corporate resources. In societies like the U.S. where labor law is weak, corporate boards make decisions to “maximize shareholder value” without regard to its effects on labor. In Germany, where labor law is well developed, workers have representatives on boards of directors and are viewed as partners in business decision-making. Obviously, these differing arrangements could greatly affect corporate strategies in the deployment of capital.

### Corporate Governance and the Problem of Efficiency

At the heart of the literature on law and corporate governance is the question of whether or not some set of rules promotes economic efficiency more than others. This claim is somewhat vague. Neoclassical economists view efficiency as the outcome of the optimal allocation of land, labor, and capital by a firm given the various prices of these resources. Economies of scale and scope represent how firms make investments to produce the most goods for the lowest prices. Economists have considered other ways in which efficiency might emerge. They have focused attention on the minimization of

transaction costs (Williamson 1975; 1985), agency costs (Jensen & Meckling 1976), and reaching a Nash equilibrium in a game (Tirole 1988). In order to assess efficiency empirically, economists study the performance of firms (profits, return on capital) or whole national economies (where the dependent variable is frequently measured by changes in GDP).

Historically, economists have been skeptical of the claim that political, legal, or cultural factors affect efficiency. Most economists think that price signals are central to the efficient allocation of resources and most responsible for making things efficient. But economists have shifted away from their position that efficiency is purely about rational actors making decisions about the allocation of productive assets and have begun focusing on social arrangements like contracts in the context of, for example, firm governance, as we discuss more below. Their attempt to view institutions like contracting and the construction of the boundaries of the firm as efficiency enhancing moves them toward sociology and organizational theory. Economists have gone from this focus on contracting to a more expansive view of the kinds of institutions like law, trust, and “good” government that might affect market outcomes (Berkowitz et al. 2003, Carlin & Mayer 2003, La Porta et al. 1997a, b; 1998; 1999b, Mahoney 2001, North 1990).

The institutionalist position within law and economics that has dominated discussions of efficiency and corporate governance in the past 25 years is agency theory. We will use agency theory as a foil to explore how other social, political, and legal factors might affect corporate governance. Agency theory views the firm as a nexus of contracts and as such sees the firm as a “useful fiction” (see Jensen & Meckling 1976 for the classic statement of this position and Fama & Jensen 1983 a, b for a more didactic



explication; see Hansmann 1996 for a longer excursus on the evolution of ownership forms and the ultimate domination of the public corporation in the U.S.).

One can conceive of all relationships within the firm and between the firm and other firms as being bound by contracts. These contracts frequently have a hierarchical structure where a principal delegates responsibility to an agent to perform some task. The contract that is written specifies rights, duties, and compensation of agents and frequently provides some mechanism by which the principal can monitor the agent. The problem that agency theory set out to solve in the 1970s was why there appeared to be a separation of ownership from control over the large corporation in the U.S.

Beginning with Berle and Means (1932), a long history of scholarship had argued that this separation was inefficient. It suggested that managerial control led to firms making investments to stabilize firms by preferring growth over profits (i.e., managers pursuing less risky investments in order to preserve their jobs) and to produce perks for themselves (Marris 1968, Penrose 1959). The problem with this theory was that all available evidence suggested that firms controlled by managers performed at least as well as owner-controlled firms (for a review, see Short 1994). It should be noted that efficiency in this case was usually measured by comparing profit rates across firms with different ownership types. These consistent empirical results caused some economists to re-think the problem and attempt to figure out why the separation of ownership and control was efficient.

Agency theory began by arguing that in modern capitalist economies, firms need to raise sufficient money to produce complex products and take advantage of economies of scale and scope. On the one side, the managers who ran these firms lacked the capital

to do so. On the other side, there existed people with money who could be owners but lacked either the expertise or the interest to run the firm. To solve this problem, the principals (i.e., the investors) would give their money to agents (the managers) in order for those managers to make profits and assure those principals of maximum returns on their investments. The main problem was that the owners of capital who lacked information about how to produce the product were potentially at the mercy of the managers, the agents. This produced the problem of monitoring those agents. The cost of doing this monitoring is called agency costs. There were a number of solutions to this problem. Boards of directors would have a fiduciary duty to shareholders to monitor the managers. Managers' compensation could be tied to firm performance thereby aligning their interest with the interests of owners. Disclosure laws would require timely filing of operational and performance results to current and prospective investors. Agency theory posited that if managers still behaved badly and boards of directors ducked their fiduciary responsibility, the existence of a market for corporate control would provide the final check on managerial opportunism (Fama & Jensen 1983a, b).

In this story, corporate law and financial market regulation make it possible for minority shareholders who have little access to the internal workings of the firm to gain knowledge of how firms are doing financially. In essence, these laws solve the agency problem by specifying rules governing the disclosures and governance of public corporations. In exchange for being able to raise capital publicly, teams of managers must make information available to the public and be governed by a board of directors (Hansmann 1996). Thus, the separation of ownership and control in large U.S. corporations is thought to efficiently solve the problems of firms for capital and the need

for investors to be guaranteed a fair shake by teams of managers. Note that for agency theorists, these laws and arrangements are created to meet the functional needs of owners who prefer not to directly administer firms. These arrangements are deemed efficient because they maximize the returns to these owners by lowering agency costs.

For agency theorists (mostly economists, but a few law professors as well), history, culture, and politics are irrelevant for the issue of how to get the right mix of (i.e., efficient) investments made in a particular economy. In essence, societies that “discover” this complex, but elegant solution to the problem of raising large sums of capital by separating ownership from control and insuring that managers use capital wisely (i.e., minimize agency costs) will prosper precisely because the shareholder wealth-maximizing investments will get made. Societies that try and pursue goals other than shareholder wealth maximization through their corporate governance structures or ignore this problem of agency costs entirely are doomed to underperformance because their capital markets will not be deep enough to allow the most profitable (efficient) investments for owners (see Jensen 1989 for a rhetorical defense of the American system along these lines).

This clean story has lots of power, and it has captured the intellectual imagination of many scholars in economics departments and law schools. But the story has several flaws. First, it argues that the functional needs of owners of capital drive the creation of institutions and that therefore whatever institutions survive are by definition efficient. The problem with this story is that the creation of these markets, even in the U.S., was a political and historical accident (Roe 1994). Roe documents that in the 1930s, the U.S. government passed a series of laws forbidding banks and other financial institutions from

controlling industrial corporations. These laws were passed for populist reasons and their intention was to prevent the concentration of economic power in the hands of a few powerful financial institutions. They were not passed to produce efficient capital markets or to solve agency problems of firms. Second, these institutions did not emerge anywhere else in the developed world (with the exception of Great Britain which began to develop these institutions by mimicking the U.S. case during the 1980s, see Vitols 2001). Moreover, Japan, Germany, France, Italy, the countries in Scandinavia, and more recently Taiwan, Singapore, and South Korea, have attained high levels of industrial development without producing American style institutions or deep capital markets (Hall & Soskice 2001, Roe 2003, La Porta et al. 1998), suggesting that the U.S.-style of public firms may be a localized phenomenon generated by elements of historical and political forces unique to the United States.

These kinds of results present two problems for efficiency analysis. First, they suggest that systems of corporate governance are more political and historical outcomes than efficient solutions to the functional needs of the owners of capital who seek to maximize profits for themselves. Second, the fact that many societies appear to have experienced comparable economic growth without converging on a single form of corporate governance (i.e., that of the U.S.) suggests that there is no set of “best practices” of corporate governance but rather many sets of best practices and that the relationship linking these institutions to good societal outcomes like economic growth are more complex than agency theory would allow.

The scholarship can be broken down into two camps around these issues. First, some institutional economists have recognized that political, cultural, and legal factors

might indeed operate as independent variables to affect the organization of firms (La Porta et al. 1997 a, b; 1998, Demirgüç -Kunt & Maksimovic 1998). They have been joined by a number of political scientists who have been interested in the question of how public policy might be harnessed to produce better economic growth (Albert 1993, Berger & Dore 1996, Boyer & Drache 1996, Crouch & Streeck 1997, Streeck 1992). These scholars have engaged in an ambitious project to document what these differences in political and legal systems are and what kinds of capital markets and corporate governance systems they tend to produce. While they are prepared to believe that the creation of these institutions related to how firms are financed and owned did not solely involve efficiency considerations, these scholars continue to maintain that some institutions might be more efficiency enhancing than others.

Their approach is to argue that the same set of agency problems (i.e., the problems of owners and managers) and the need for firms to obtain capital are solved differently in different societies because of the opportunities and constraints of the existing political and legal systems. This has produced an interesting literature on the study of comparative capitalist systems that focuses on how the particular relationships among owners, managers, and workers evolved (La Porta et al. 1997a; 1998). The literature is willing to accept that there may be more than one path to development. But, economists and political scientists would still like to believe that even if corporate governance structures are largely shaped by the political and legal context, there still may be ways to resolve problems of external finance and optimal monitoring of managers that ultimately are more efficient and thereby produce more economic growth than other institutional arrangements. They have produced a large number of interesting papers that

try and quantify these differences and to show that they are consequential for societal economic growth.

The second camp is more agnostic about the ultimate linkage among institutions, efficiency, and economic growth (Bebchuk & Roe 1999, Fligstein 1990; 2001, Hall & Soskice 2001, Maier 1987, Roe 1994; 2003). These scholars document how political, cultural, and legal systems interact with firms and over time produce a system that reflects less efficiency considerations and more the outcomes of particular political, social, and economic struggles. An interesting subtext in this literature (sometimes more explicit, sometimes less so) is that economic growth, at least in developing countries, come about more because stable political institutions exist to enable such growth rather than because some exact configurations of laws and institutions were generated. Scholars who have studied development have drawn similar conclusions. Developing societies need stable governments that do not rent seek too much (i.e., who are so corrupt that payoffs, bribes, and extortion are regular ways of doing business), help resolve class struggle, let private actors accumulate wealth, and generally provide for public order (Evans 1995, Evans & Rauch 1999, Wade 1990, Weiss 1998). In other words, it seems less important that specific sets of laws or specific solutions to societal problems like class struggle be implemented to create economic growth but rather that stable societal conditions exist more generally.

A Conceptual Approach to Politics, Society, Culture,

Law and Corporate Governance

In order to explore more fully the tensions produced by these different scholarly positions, we now turn to Figure 1. Institutionalists in economics, sociology, and political science all agree that societal conditions give rise to governance structures of firms (defined as corporate law, financial market regulation, and labor law). They identify a number of societal institutions as potentially important. First, the political system of a particular society (i.e., democracy vs. dictatorship) and the existence of the rule of law are important pre-conditions for understanding corporate governance structures. The cultural tradition of the legal systems, such as whether or not they have civil or common law legal systems, is part of this apparatus as well. Some scholars (La Porta et al. 1997a; 1998; 2000a, Shleifer & Vishny 1997) have identified the most important feature of the common law systems for corporate governance to be the protection of minority shareholder rights.

(Figure 1 about here)

Second, class struggle, defined here as the conflict between owners and workers, plays out in the politics of societies (Roe 2003). These conflicts and their resolution greatly affect the nature of ownership relations (including the rights of minority stock holders), the development of financial markets, and labor law. Third, the religion of various societies plays into the political system in several ways. Some religious traditions are more tolerant and promoting of wealth generation than others. Another source of social solidarity is the shared values and assumptions that people hold about one another. In societies that are homogeneous, there is a great deal of trust and this presumably shapes the types of corporate governance that exists (Coffee 2001b).

The general argument in both camps is that these more general, contextual factors of politics and culture shape and produce the legal institutions of corporate governance in a given society and, by implication, firm practices. All of the institutionalist literature agrees that the larger, contextual factors of politics and culture shape corporate governance institutions. The main difference of opinion is that the more sociological and historical approaches see these national differences in corporate governance systems as generated by historical accidents and larger social processes and discount the role of microeconomic processes involving agency costs.

Some institutional economists and law and economics scholars, on the other hand, treat political and legal institutions as exogenous variables that affect the size of agency costs. The resulting sets of corporate governance institutions, therefore, reflect how rational economic actors deal with agency costs created under differing political, societal, and legal contexts. Here, then, rational economic actors choose corporate governance arrangements that minimize agency costs to them. For example, the common law system of the U.S. has led to strong protection of minority shareholder rights. These in turn, have reduced agency costs of monitoring and thus, some have argued, opened up capital markets to firms and reduced the influence of majority shareholders (La Porta et al. 1997a; 1998). We will consider these kinds of arguments in some detail.

### Societal Conditions and the Comparative Study of Governance

The starting point of discussion for institutional economists, political scientists and legal scholars who study corporate governance systems is the acknowledgement that



there exist multiple systems of corporate governance around the world (Berger & Dore 1996, Blair & Roe 1999, Boyer & Drache 1996, Cioffi 2002, Coffee 1999, Gourevitch 2003, Hall & Soskice 2001, La Porta et al. 1997a; 2000a, Roe 2003). Scholars have tended to cluster corporate governance models around four paradigms while acknowledging that national and regional characteristics are also apparent. The U.S. model contains dispersed shareholders who provide the bulk of the financing to large, public firms. These firms are directed by management teams that are constrained by boards of directors. Workers have few rights and no representation on boards. In the U.S., outside directors, private watchdog entities (such as accountants, securities analysts and bond-rating agencies), and government authorities like the Securities and Exchange Commission, keep information flow open and play a role in keeping managers in check. Incentive compensation for managers, and takeovers and proxy fights also provide competitive market mechanisms designed to align management interests more closely to those of the shareholders. The U.S. model (what has been called the model of “shareholder capitalism”) characterizes corporate governance in Great Britain, Canada, Australia, and New Zealand.

The German model has large stock shareholders, often comprised of founding families, banks, insurance companies or other financial institutions who own the bulk of the shares. This close ownership structure enables large shareholders to internally monitor the day-to-day operation of the firm. Cross-shareholding among insiders is common and information flow is controlled and opaque. Stakeholders such as organized labor play a substantially greater role in the governance of corporate firms under the German model. In Germany, a co-determination system exists that provides

representation of workers on boards of directors (Roe 2003). Norms of shareholder capitalism do not automatically prevail over the claims of other corporate stakeholders in countries that exhibit the concentrated ownership model. The German model (or variants of it) dominate across continental Europe and parts of Asia, including Japan.

A third model is government ownership of firms. Here, large firms and the financial sector are owned and operated by the government. While there has been substantial privatization of state owned firms in the past 20 years, in many developed and developing societies, there is still substantial government ownership of firms. This is particularly true in sectors like banking, natural resources, utilities, and transportation. Since employees are government employees, they tend to have careers guided by bureaucratic rules and fixed benefits. A final model, one that dominates most of the developing world is the model of family owned business (La Porta et al. 1999a). Here, owners are managers. Firms are private and equity and debt markets tend to play minor roles in the provision of capital. Workers generally have less power.

Of overriding interest is what accounts for this variation in corporate governance regimes. Figure 1 presented some of the political, social and cultural mechanisms that scholars have thought structured the institution of corporate governance. It is useful to go through some of the empirical literature to highlight how scholars have conceptualized the ways in which these factors have had causal effects on governance structures. Mahoney (2001) suggests that politics played an important role in the construction of a common law system in Great Britain and civil law system in France. He argues that in England the common law system resulted from the victory of private landholders over the king and nobility. Here, the law worked to prevent arbitrary seizure of land by the

sovereign. In France, Napoleon created a civil law system precisely because he did not want judges to have the discretion to restore feudal privileges after the French Revolution. The German civil law system generally provides for the independence of judges and the protection of individual property rights, and, Mahoney suggests, operates as a kind of hybrid system that has proved effective in promoting economic growth. One proof of the efficacy of the German system is that it succeeded in helping German development and was borrowed by Japan and Korea (two societies that have as a result also experienced economic success).

A large number of studies have shown that common and civil law systems appear to correlate with certain features of property rights and financial markets. La Porta et al. (1998) show that legal origins affect creditor rights, shareholder rights, and bank and stock market developments. Subsequent research links these systems to corporate valuations and ownership concentration (La Porta et al. 2000a, b; 2002b) and firm access to external finance (Demirgüç-Kunt & Maksimovic 1998).

Roe (1994; 2003) argues that the main form of politics relevant to understanding corporate governance is class struggle, i.e., the conflict between managers and owners and workers. Where managers and owners have the upper hand, corporate governance institutions favor shareholders over stakeholders. There is frequently a separation of ownership from control in publicly held corporations and stock ownership is dispersed. Workers have little formal power over boards of directors. The U.S. is an extreme case here. Where workers have more power, as they do in many of the European social democracies, corporate governance institutions tend to favor concentrated ownership of firms. Workers are frequently represented on boards of directors or at the very least have

mechanisms in place to communicate with top management. Here, Germany is the extreme.

Shleifer and Vishny (1989; 1993; 1994a, b) argue that government officials can potentially affect corporate governance institutions if they are able to rent seek. This will result in official corruption that is likely to negatively affect corporate governance institutions. Djankov et al. (2003) refine this argument and suggest that developing societies sometimes face a trade-off between political disorder and dictatorship. In a situation of political disorder, there will be few stable institutions, low investment, and low economic growth. But a dictatorship may be able to create political and social order. While there are many cases where dictators use their power for rent seeking behavior, there are also examples where dictators pursue good economic policies might actually aid economic growth.

Another kind of historical accident that has had a profound effect on corporate governance is the transplantation of corporate governance institutions. Because of colonialization, many societies were forced to take the corporate governance system of their respective conquerors. Acemoglu et al. (2001) make a provocative case that societies where Europeans actually settled (like the U.S., Canada, Australia and New Zealand) fared better than societies that were colonized and exploited mainly for mineral wealth (like most of the societies in Africa and Latin America). Berkowitz et al. (2003) show that the legitimacy of a legal system was effected by the conditions under which it was transplanted and this legitimacy had a big effect on the subsequent efficacy of the legal system. They argue that where institutions were forced on populations, they enjoyed less legitimacy and failed to produce an effective rule of law. Beck et al. (2003) show

that both the extent of European settlements in various colonies and the type of legal system (i.e., civil vs. common law) that was adopted in various societies have affected property rights regimes and the evolution of financial institutions.

War, revolution, invasion, colonialization, class struggle, and politics have been at the heart of how societies have come to differentially structure their economies and the organization of their corporate governance institutions (Roe 2003). Ethnic and religious differences also appear to account for why some governments work better, have more legitimacy, and produce more effective systems of corporate governance (Coffee 2001b, Easterly & Levine 1997, La Porta et al. 1997b; 1999b, Stulz & Williamson 2003). There is little evidence that these corporate governance institutions arose as a result of efficiency considerations (Djankov 2003, La Porta et al. 2000a, Shleifer & Vishny 1997). Most societal rules and laws are products of political processes, processes that reflect the relative power of various organized social groups. Incumbent groups work to produce benefits for themselves and costs and constraints for their challengers. Culture, indexed by religious traditions and solidarity that generates trust in a population, also appear to affect such laws.

#### Social and Political Institutions, Law, and Economic Growth

This presents us with a puzzle. In spite of the use of political and legal systems to forward the interests of particular groups and cultural barriers that make markets more difficult to organize, market society has advanced in Western Europe, the U.S. and now parts of Asia. In spite of obvious rent seeking by governments and capitalists, there has

been amazing growth in incomes and wealth. Somehow, political, legal, and social institutions were able to create enough social space such that private actors were able to organize firms, production, and markets. This has led scholars across disciplines (Djankov et al. 2003, Evans & Rauch 1999, Fligstein 2001, Glaeser et al. 2004, La Porta et al. 1999b) to suggest that having institutions that produce stable laws and peaceful governments without too much rent seeking on the part of any group of social actors may be the necessary and sufficient condition by which development occurs.

Still scholars cannot help but wonder if there is some set of political and legal institutions that produce corporate governance structures that might in the long run prove more efficient than other institutions. In other words, even if actors did not rationally set institutions into place in order to produce efficient outcomes for firms and investors, it still might be the case that there are distinct advantages to one system of corporate governance over another. If policy makers could pinpoint what these are, so the story goes, they could encourage countries who wanted to improve their economic performance to adopt this set of “best” institutions. The search for the single “best” set of institutions has been the holy grail of the economics and political science literature for the past 20 years. Scholars have chased the chimera of institutional causes of economic growth as first Japan (Johnson 1982) and Germany (Albert 1993, Streeck 1992), and then Italy (Locke 1995), the so-called Asian tigers (Amsden 2001, Orru et al. 1997, Wade 1990) and now China (Guthrie 1999, Nee 1992) have all embarked on rapid economic growth. Scholars have researched and debated whether each of these societies has somehow discovered the “right” configuration of institutions.

In this section, we will review some of the literature that attempts to show how particular corporate governance institutions have performed over time. It should be noted that “efficiency” in this literature is mostly indexed by growth in GDP per capita. The rationale animating this research is that the purpose of corporate governance is to produce the “right” set of incentives for investors by helping them procure finance, solve their agency problems, and contract with their workers. Those societies that manage to establish governance systems that solve these problems get people to make investments and grow their firms. This growth virtuously sums up across firms and economic sectors to produce economic growth for the society as a whole. The literature tries to compare these institutional arrangements across societies and across time in order to assess their relative effects on economic growth. Some of the literature uses aggregate data and sophisticated econometric techniques and other parts of the literature use case studies

One must be cautious about this literature. In order to believe that a system of governance affects long run economic performance, one has to assume that on average all firms in a society do better with a particular set of governance institutions. Moreover, institutions change very slowly while firms frequently rise and fall, indicating that in order to adjudicate among various sets of corporate governance institutions, one must undertake an analysis of economic performance in various societies over long stretches of time. Finally, there are many factors that affect economic performance of economies and separating out the effects of institutions from these other causes is difficult. To view long run economic growth as the outcome of a stable set of corporate governance institutions seems a remarkably heroic assumption.

There is a deeper problem as well. Firms compete in various industries and the industrial mix of societies varies. The sectoral mix of industries and the organizing capacities of those industries will profoundly affect economic growth over time independent of corporate governance institutions. Equating general economic performance with overall firm performance and attributing this to the broader legal conditions in a society does not take this differential distribution and performance of industrial sectors into account. Instead, it makes the strong assumption that these do not matter: only the legal arrangements of firms matter. But the evidence for this assertion is quite circumstantial. There have been no studies to date that try and set forth the relationship between firm performance in different political-legal environments and overall economic performance. Having set forth this cautionary note, it is useful to consider some of the literature on political and legal institutions and economic growth.

The issue of property rights concerns whether or not ownership rights are assigned to individuals. Ownership rights imply that if a person makes investments, they will be able to reap profits from those investments. There are several mechanisms by which this affects economic growth. First, if individuals do not have ownership rights over the returns on their investments, they will not invest. Second, even if they do have these property rights, if profits are subject to seizure either by governments or other private actors (legally or illegally), they will not make investments. Finally, governments that own property will crowd out private economic actors. They will do this because they will create monopolies for themselves. They will also likely make investments that are not efficient and instead will make investments to reward their friends by giving them jobs and opportunities to rent seek.



There is substantial evidence to support the importance of property rights in the rise of the West (North & Weingast 1989). Hurst (1977) and Friedman (1973) have argued that the creation of the modern corporate form endowed with ownership rights over goods and assets allowed economic development to proceed in the U.S. Research by de Soto (1989) has documented how defining property rights in developing societies is an important mechanism to produce economic growth. The literature on state ownership of firms has demonstrated that generally government-owned firms perform less well than their private sector counterparts (Barberis et al. 1996, Boycko et al. 1996, Frydman et al. 1999, Lopez-de-Silanes et al. 1997, Megginson et al. 1994). When governments privatize firms, firms generally begin to perform better.

One of the largest bodies of literature exists regarding the role of financial markets in economic development (Demirgüç-Kunt & Maksimovic 1998, King & Levine 1993, Rajan & Zingales 1998). Here the consensus is that the existence of a developed banking system and stock market is generally positively related to subsequent economic growth (for a review, see Levine 1997). The literature begins with the idea that if financing is not available, people will not be able to raise money to build firms that might produce economic growth. Thus, one of the central problems of economic development for any countries is matching people who have money with people who need financing to build firms. Gerschenkron (1962), an economic historian, is most frequently credited with coming up with this insight. One of the most interesting questions for developing and developed societies is how financial services are provided.

We earlier discussed the ways in which banks, corporations, and financial markets embed the four ideal typical models of corporate governance (Roe 2003, Shleifer &

Vishny 1997). The Anglo-American model is one where corporations rely on corporate equity (i.e., stock markets) and debt (i.e., bond markets) for most of their financing. In the German and Japanese model, banks own shares in firms and tend to loan those same firms money. In these societies, equity and debt markets are much less developed. Not surprisingly, ownership is more concentrated in these societies. The third model is state ownership of banking systems, like in Korea and France (until recently). The fourth model is one in which owners and their families provide the capital to finance the expansion of closely-held firms.

The empirical literature presents mixed results on which model produces the most economic growth. While there is some evidence that government ownership of banks is detrimental to growth (La Porta et al. 2002a), there is also evidence that such support played an important role in the development of Korea, Taiwan, and perhaps China (Wade 1990, Amsden 2001). While there are scholars who believe that the American system of dispersed stock ownership and deep equity and bond markets is most conducive to efficient investment (Hansmann 1996, Hansmann & Kraakman 2001, for example), the empirical evidence is more mixed (see Levine 1997). Indeed, there is evidence that banks and financial markets independently produce economic growth. Levine (1997) argues that in modern advanced industrial societies, they actually serve different functions in the economy.

The literature on how labor laws affect economic outcomes is the least developed. There is evidence that less developed societies have labor laws that make it more difficult to hire and fire workers than advanced industrial societies (Botero et al. 2003). But advanced industrial societies have broader welfare state policies such as unemployment

insurance, welfare, and social security (Garrett 1998, Hicks 1999). These offset the insecurity produced by looser laws regarding hiring and firing by cushioning workers from unemployment spells.

There is no systematic evidence that shows that workers' organizations, workers' rights and welfare state expansion have influenced long run economic growth (Garrett 1998, Hicks 1999, Rodrik 2003). The evidence shows that the social democratic countries of Western Europe did offer more social protection and higher benefits than the Anglo-American countries (U.S., Great Britain, Australia, New Zealand, Canada). These employment and labor protection measures also helped reduce income inequality in those countries. A recent OECD report on jobs tries to look at how various forms of collective bargaining have affected economic growth and job creation in OECD countries in the past 20 years (1997). The results are worth quoting: "While higher unionization and more co-ordinated bargaining lead to less earnings inequality, it is more difficult to find consistent and clear relationships between those key characteristics of collective bargaining systems and aggregate employment, unemployment, or economic growth (1997: 2)."

It is useful to summarize these results. The literature shows that having well defined property rights that grant ownership of profits to individuals is generally positive for economic growth. It also shows that well developed financial institutions offer would-be entrepreneurs the opportunity to grow new firms. The literature is less clear on whether one particular system of organizing financial markets is superior to any other and even suggests that banks, stock and bond markets all generate comparable economic growth. Finally, there is little evidence that labor laws that provide more extensive

worker rights and welfare provisions inhibit economic growth. One could conclude that rent seeking on the part of either firms or governments is detrimental for economic growth. But, there is little evidence that “rent seeking” (i.e., getting the government to create welfare states) on the part of labor does anything more than redistribute income and produce social justice. This leads us to an interesting conclusion. Rather than looking for a single “way” to organize economies to maximize economic growth, it might make more sense to understand what general sorts of economic problems a wide variety of institutions solve.

This leads us to consider more broadly several claims in the literature: first, that common law systems are better than civil law systems at producing market-enhancing environments, and that how Western style law and governance were adopted by and inserted into various societies affected economic growth around the world. In a provocative series of papers, La Porta, Lopez-de-Silanes, Shleifer, and Vishny (hereafter LLSV) have tried to document how countries with common law systems have offered better growth prospects for countries than those with civil law (especially French civil law) systems.

The argument is that civil law systems evolved, first in France, but later in Germany. These systems were “top down” in the sense that lawmakers provided laws that gave judges very little discretion and preserved state power over the rights of individuals. Common law systems evolved bottom up. In England, local courts would protect the rights of the landed gentry from infringement by the king. Later, merchants would use these same courts to enforce contracts and prevent the expropriation of their property. Scholars have argued that this protection of individuals under common law systems

produces greater security of property protection and stable conditions for contracting and thus promotes economic growth (Mahoney 2001, North & Weingast 1989). In a series of papers, LLSV try to evaluate this claim by producing econometric models for a wide variety of countries with a large number of controls. They end up arguing that common law systems do produce superior economic growth. They claim that the main mechanism for this growth is the laws that protect minority shareholders, which common law countries provide more extensively and enforce more effectively (La Porta et al. 1997a; 1998). Laws that protect minority investors promote diffuse ownership of large public firms and the separation of owners from managers. These developments, in turn, allow for the growth of deep and liquid capital markets that generates a more extensive source of external financing for firms.

This claim has sparked an outpouring of research. There are several problems with the basic result. First, legal scholars have tended to dispute the validity of the legal index LLSV generated to measure what they claim are critical minority shareholder rights around the world (La Porta et al. 1998). Some scholars have voiced doubts as to whether LLSV have constructed an accurate legal index that meaningfully measures different degrees of investor protection in their sample of countries. (Coffee 2001a: fn.6, Roe 2003). In the U.S., for example, corporate law provisions that provide for shareholder rights and compensation for corporate losses limit judges to consider only managerial malfeasance that involves fraud or self-dealing. Incompetence or shirking on the job that result in massive shareholder losses are not open to judicial review (Roe 2003). The legal index may obscure the degree to which legal provisions that it highlights are truly relevant for measuring effective protection of minority shareholders in different countries.

Second, the practical impact of formal laws is difficult to gauge from a reading of the laws on the books. Local practices, functional substitutes and business norms bolster, shape, attenuate or even eviscerate the actual impact of formal laws.

Lamoreaux and Rosenthal (2004) argue that the civil law system, in fact, provided greater latitude in forms of business organizations and in contracting to individual investors in the 19<sup>th</sup> century and through most of the 20<sup>th</sup> century in France compared to the common law system in the U.S. They also hint at a particularly important problem for evaluating LLSV's hypothesis. LLSV assume that institutions, like the common or civil law systems, once laid down, never change, either in their meaning or impact. In fact, as conceptualized by LLSV, legal regimes are exogenously established in a one-time event of colonization or conquest and their effects remain static. Yet, Cioffi (2000) shows that in fact corporate governance institutions changed in France, the U.S., and Germany, and Great Britain during the 1980s and 1990s. Coffee (1999) indicates that formal legislation follows rather than precedes business practices.

Another criticism of the LLSV measures (especially the measure for civil or common law systems) is that they are stand-ins for other variables. For example, common law systems tend to be in societies that are peaceful and democratic (like the U.S.) while civil law societies tend to be wracked by war and poor economic conditions (as in Africa). This has led scholars to offer alternative explanations for the differential institutional structures that affect economic performance. For instance, Acemoglu and his colleagues (2001) have argued that in countries where settlers were able to homestead, live and expand (like in the U.S., Canada, Australia and New Zealand), institutions that guaranteed private property rights and checks on government were transplanted, which

promoted economic growth. Where conditions were more difficult, like sub Saharan Africa and much of Latin America, colonial powers chose more extractive strategies. They set in place repressive regimes that mostly maximized the extraction of mineral and other forms of wealth. These institutions persisted and hindered the growth of a post-colonial political economy that restrained government and protected private property.

Others have tried to put variables measuring both common/civil law systems and measures of settler mortality to test these competing hypotheses set forth by LLSV and Acemoglu et al. into equations predicting economic growth. Beck and his colleagues (2003) find some evidence to support both theories but conclude that Acemoglu et al.'s explanation seems the stronger of the two. In a recent paper, Berkowitz and his colleagues (2003) argue that the mode of insertion of these systems is critical. Where countries were forced to accept systems of institutions that were not indigenous or poorly adapted to local circumstances, economic growth was slower. These scholars were able to make the effects of civil/common law systems disappear once they controlled for the mode of insertion of such institutions.

One big criticism of much of this empirical literature is the constant misspecification of models. Scholars rarely control for many factors. So, for example, in a paper analyzing the role of institutions in economic growth as compared to investments in physical and human capital, Glaeser et al. (2004) show that human capital is a much stronger predictor of economic growth than institutions. Since many of the earlier papers failed to include controls for human and physical capital investments, their results may be suspect.

Papers rarely pit all of the variables from the different perspectives against one another in order to do a fair evaluation of those variables. When such models are run, they frequently provide evidence to support multiple hypotheses. It seems more probable that economic growth is a multidimensional process that reflects many social and political institutions. There are many factors that enter into such growth and many institutional paths to growth. These lively debates show the difficulty of trying to assess the effects of a particular set of social or economic institutions on economic growth.

### Conclusions

In the past 20 years, there has been a great deal of interest in comparing the evolution of institutions across market societies over time. Some of the impetus came from economists who wanted to prove that the American system of corporate governance was the best because it evolved from the functional needs of investors. Others wanted to understand how Japan, Germany, Italy, the countries in Scandinavia, Korea, Taiwan, and now China have managed to produce incredible economic growth in the past 40 years. Still others have been concerned about the causes of economic stagnation in Africa, Latin America, and Russia. In the past few years, globologists (Strange 1996, Castells 1996) have argued that political, social, and economic institutions were bound to converge as firms sought out efficient ways to organize.

Our survey of the literature analyzing the relationships among law, corporate governance, and economic outcomes produces a different picture. Generally, most scholars agree that corporate governance institutions like property rights, the organization



of financial markets, and labor laws reflect the politics, culture, and history of particular societies. Most systems of governance were not produced by investors seeking out laws and institutions to reduce agency costs, but instead arose out of struggles over the rights and roles of capitalists and workers in democratic and authoritarian societies. The legal systems that evolved reflect the outcomes of these struggles and have had a profound effect on the national structures of corporate governance.

Despite the view that economic institutions did not evolve for efficiency reasons, scholars have been quite interested in understanding how institutions have, in the end, played an important role in capitalist development. Here, there is little controversy. Stable property rights and evolved financial systems play a key role in economic development. Labor laws figure into economic growth because they buy labor peace. In societies that mediate class struggles, either by repressing the working class (like America or China) or by empowering them (like the social democratic countries in Europe), economic development is facilitated.

Controversy revolves around the degree to which different legal regimes are more or less efficient than other systems. The differential role of civil and common law systems on stable economic growth is still being debated and explored. There are a number of conflicting opinions. First and foremost, scholars debate the possible reasons why common vs. civil law systems may have differential impacts on development. Some believe that common law systems protect individual rights more than civil law systems and that this has a bearing on economic growth. Others think that common vs. civil law measures index other features of societal development like how these societies were settled, how the institutions were inserted, and the degree to which they were considered

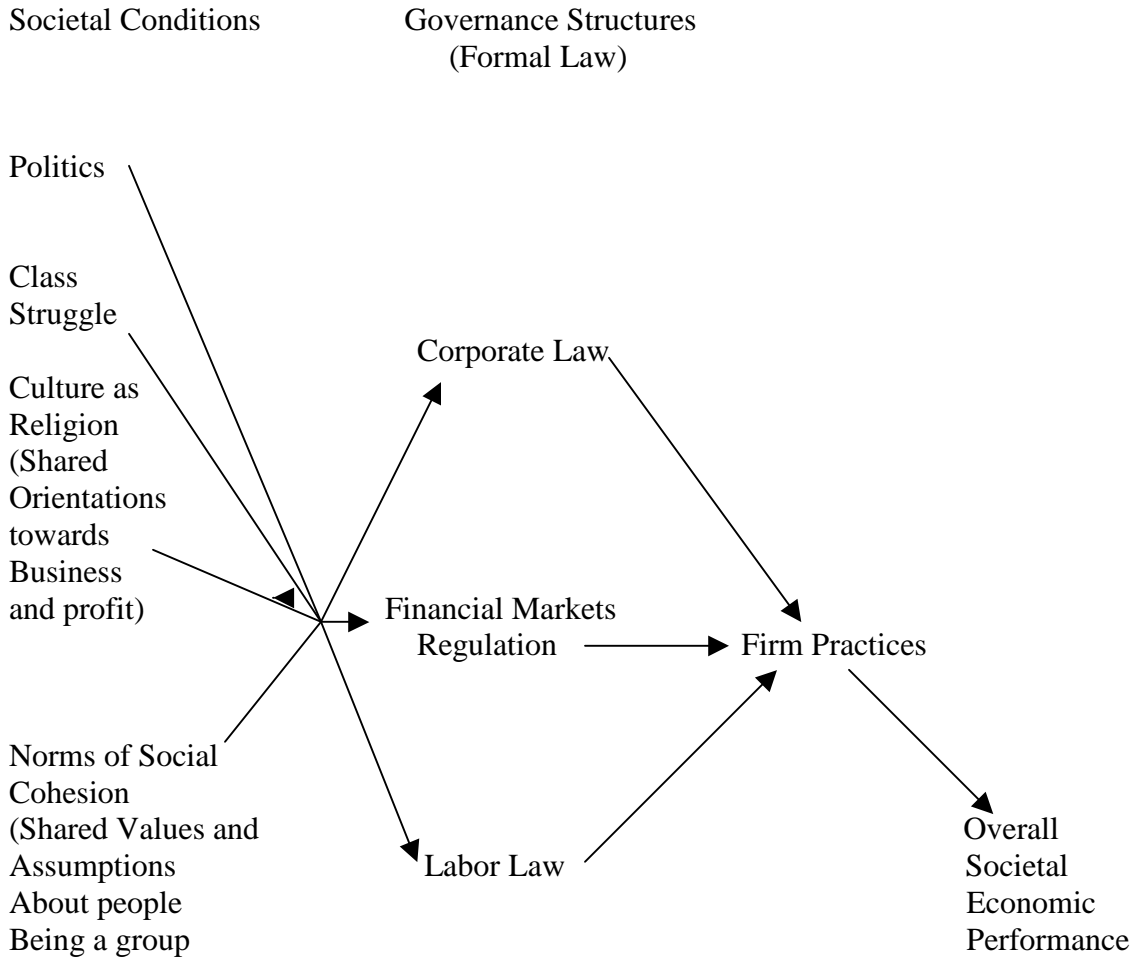
legitimate. Another big debate concerns the role of politics, religion, ethnicity and culture in the economic evolution of societies. Again, the causal mechanisms by which these factors foster economic growth are hotly debated. Finally, some scholars think that there are many paths to economic development. Others argue that there is one best way to organize the political economy of a society. The empirical literature, on the contrary, suggests that the relative advantages of particular legal institutions are difficult to tease out, and even where they can be discerned, do not suggest the dominance of one best system.

This result suggests some clear and interesting paths for subsequent research. First, we think that comparative studies in institutions and economic growth must be analyzed longitudinally within countries, as they evolve over time. Linking institutions, institutional change, and economic growth together more carefully in some societies might reveal more closely when and why institutions matter. Such research will also begin to untangle the kinds of feedback that are possible between institutions and economic actors. As societies develop and new interest groups appear, for example, such developments may alter institutions. We also know that institutions that exist set up the possibilities for new institutions. It seems useful to tease out such trends and dynamics over long historical periods. Finally, scholars ought to take seriously the possibility that there may be many paths to economic growth (including ones not yet discovered) and that solving certain kinds of broad societal problems, like class struggle and ethnic and religious conflict may be as or more important to economic development as adopting a particular set of legal institutions.

One also needs to be aware of the fact that national corporate governance systems appear to be systems. The literature shows clearly that institutional features of property law, financial market regulation, and labor law tend to hang together in various societies. This understanding is somewhat in opposition to much of the empirical literature, which tends to treat these legal elements as discrete variables. The variable approach seems to imply that importing some institutional facet linked to economic growth will work like a panacea to cure inefficiency and generate high growth. But, the importation of someone else's corporate governance institutions is likely not to work, unless the whole system is borrowed or the borrowed element fits in with what already exists in a given society. Scholars need to be more modest in their claims for a particular law or set of practices and more attuned to the fact that societal institutions tend to be national systems.

What seems to be clear is that Weber, Marx, and Durkheim all picked up important aspects of the development of a market society. States that create social stability by mediating class struggle and engage in protecting property rights appear to be pivotal to economic development. Legal systems that support contracting and financial systems that provide access to capital to entrepreneurs are both critical ingredients for modern development. Multiple paths to solving these social and economic problems exist. The plurality of capitalist systems (what is called the study of comparative capitalisms) shows both the multiple ways in which these various systems have evolved and their robustness in generating economic growth.

Figure 1: An Institutional Model of the Relationship Linking Social and Political Factors to Law and Corporate Governance



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