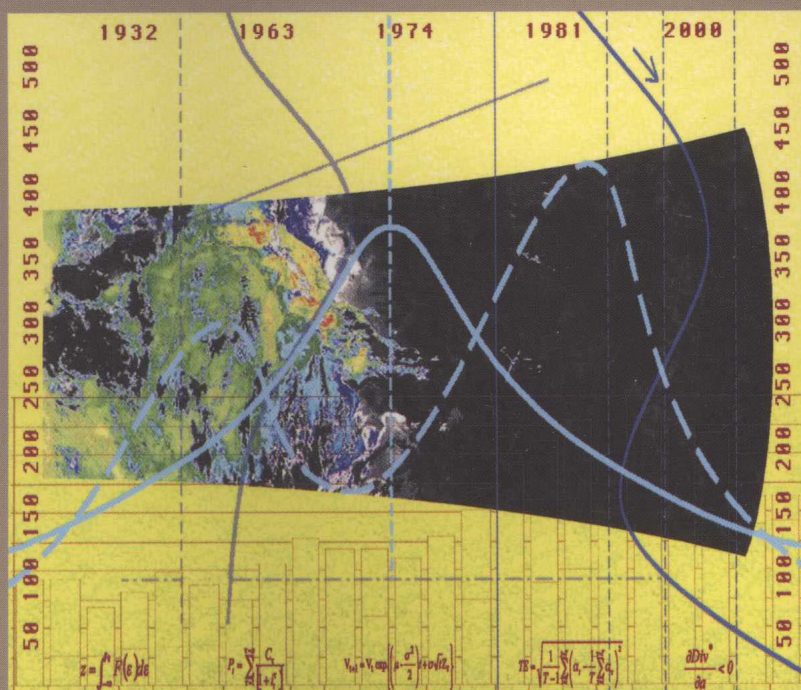


# Corporate Governance Adrift

A CRITIQUE OF SHAREHOLDER VALUE



Michel Aglietta  
Antoine Rebérioux



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A Critique of Shareholder Value

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Michel Aglietta

*Professor of Economics, University of Paris-X; Scientific  
Advisor, CEPRI; and Member, Institut Universitaire de France*

Antoine Rebérioux

*Associate Professor of Economics, University of Paris-X,  
France*

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It thus goes without saying that any errors that may remain are entirely our responsibility.

# Foreword

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The book that the reader is about to discover is the fruit of several years' pre-occupation. Its origin goes back to a project of collective research launched in 1999, on behalf of the *Commissariat Général du Plan*. One of the authors coordinated this research; the other gave it major impetus. Four research centres participated in the project: the FORUM in Nanterre, the IDEFI in Nice, the INSEAD in Fontainebleau and the CPDR of the Catholic University of Louvain. This research culminated in a report published in September 2001 and entitled: *Régimes de gouvernements d'entreprise: différences nationales et stratégies d'entreprise* ('Corporate Governance Regimes: National Differences and Corporate Strategies').

From this period on, we became mistrustful of the dominant ideology – a skilful mixture of legal and economic theory – championed by Anglo-American consulting firms, the larger investment banks and certain academic circles. In the euphoric atmosphere of large-scale stock market speculation and the golden age that the 'new economy' was expected to bring, the shareholder was king. Creation of shareholder value established itself as the pillar of a new form of governance, guaranteeing uninterrupted prosperity for the economy as a whole, including workers. There was no doubt, according to the enthusiastic promoters of this doctrine, that the whole world would convert to it. Globalization of the economy, by exerting its influence on the firm itself, would penetrate deeper strata than the level of the capital markets alone.

In the report cited above, we expressed doubts about this unilateral, indiscriminate interpretation of the transformations that were indeed shaking up the corporate world. We did not consider stock market overbidding provoked by the stimulus of shareholder value as a sustainable process. We did not see, in the frenzy of mergers and acquisitions, a restructuring process of self-evident economic efficiency. We did not observe the whole world being converted to this new religion. Because our study extended beyond the field of finance, exploring the interlacing of relations between the different partners of firms, we were contemplating a diversity of forms of governance that had no reason to disappear.

The Enron affair broke just one month after the publication of our report. It was to be followed by many other scandals. During this period, finance displayed an instability that could only be controlled through

sustained intervention, of exceptional duration and on an unequalled scale, by the Federal Reserve Board. The events that have occurred in business, in finance and in the global economy have prompted us to deepen considerably the scope of the analysis of which the 2001 report was the first milestone. It is the properties of finance-led capitalism that must be examined. To do so, we must study in detail the developments in contemporary finance, the logic of its functioning and its sources of fragility. We need to explore the nature of the modern firm, of the powers it contains and of the objectives actually pursued by its executives, without letting ourselves be blinded by the ideology of shareholder sovereignty, which persists despite the profound crisis provoked by its application. Above all, we need to analyse the close links between the expansion of market finance and the strategies adopted by firms, to highlight the perversity of a model of capitalism in which stock markets play a dominant role.

The approach adopted in this book is therefore above all analytic and positive (empirical). It is essential to deconstruct the predominant ideological discourse in order to demonstrate the deficiencies in its theoretical foundations, both legal and economic. Nevertheless, we could not avoid completely a normative point of view, which is encountered on every page written by the advocates of a form of governance oriented exclusively towards comforting the well-being of the shareholders. Essentially, our normative propositions, leading us to set one principle of governance against another, are presented in the last chapter.

At an analytic level, we therefore begin by examining the conception of finance-led capitalism which currently prevails in academic and political circles, and which can be summed up in two propositions:

- The strengthening of the finance-led model results in better risk-sharing and greater economic efficiency in the allocation of capital;
- Shareholder primacy puts an end to the usurpation of power that characterized 'managerial capitalism'. It (re-)establishes the respect of private property – the linchpin of capitalism.

Accepting these propositions leads one to foretell the 'end of history', as capitalism succeeds in imposing an efficient form of regulation throughout the world. The joint difficulties encountered by finance and corporate governance in the wake of Enron have failed to dent this apologetic vision within the dominant intellectual current. The two phenomena have been treated separately in recent literature; their interactions lie at the heart of this book. On the one hand, the stock market crash has been attributed to market exuberance. On the other hand, failures in governance have been

explained as a deterioration in managerial ethics, the origins of which are extra-economic.

Our approach, both positive and normative, lies within an institutional tradition which, though interrupted, goes back to the seminal work of Berle and Means. As early as 1932, these authors raised the issue of corporate governance that results from the separation of ownership and control. Our interpretation of this problem is radically opposed to that upheld by the champions of shareholder sovereignty. Those who advocate exclusive control by shareholders as a solution to the dilemma of separation cannot explain the paradox at the heart of the current crisis in governance. This paradox is the following: the greater the number of control mechanisms in the hands of the shareholders, the greater the exploitation of the dependency of firms on the stock markets by corporate executives for their own personal enrichment.

Against the principle of externality of the firm's objectives (maximization of the well-being of shareholders alone, in an agency relationship), we set another: the principle of the political elaboration of the firm's objectives by the board of directors, considered as a body mediating between the executives and the internal and external stakeholders of the firm. This principle raises the problem of the overlapping of market and democracy in contemporary capitalism. To the extent that it is progressing, participative democracy in France tends to be confined to the non-profit sector. The experience of Scandinavian countries in the compatibility between the preservation of social cohesion and the assimilation of innovations leads us to believe that an advance in democracy at the heart of the most essential economic institutions is indispensable to the *regulation* of European capitalism at the beginning of this new century.

## OUTLINE OF THE BOOK

We begin our analysis by defining the context in which the doctrine of shareholder value has flourished: the diffusion of information technology and financial globalization. The most relevant characteristics of these two factors in terms of corporate governance are studied in Chapter 1. We then criticize the 'end of history' thesis, in both its normative dimension (optimality of shareholder value) and its positive dimension (system convergence). Chapters 2 and 3 thus aim to 'denaturalize' (deconstruct) current finance-led capitalism, by demonstrating that the ideology it conveys is contingent to the intellectual and institutional watershed experienced by the United States at the beginning of the 1980s.

The two following chapters explore the mediations between finance and



firms, namely regimes of governance and accounting standards. The denaturalization of shareholder value leads us to examine both the diversity of forms of control (Chapter 4) and accounting representations of the firm (Chapter 5).

In Chapters 6 and 7, we study the logic of finance-led regimes and their macroeconomic effects. By highlighting the interdependencies connected with risk management, we bring out forms of instability which redistribute the systemic risk of banks towards other institutional sectors and which exert powerful influence on the economic cycle.

Chapter 8 analyses the crises in governance from the firm's point of view. It studies the lessons to be learnt from symbolic financial scandals such as Enron and Parmalat. Using concrete cases, we demonstrate that current explanations of these failures are insufficient and that the very principle of control by external shareholders must be called into question. Consequently, based on these reasoned observations, Chapter 9, after giving a synthetic presentation of the results of the whole book, outlines another conception of corporate governance founded on the idea of economic democracy.



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# 1. Finance-led capitalism: an inventory

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The starting point of this book lies in an observation: the rise to power of market finance since the mid-1970s has radically altered the characteristic traits of contemporary capitalism. This process of ‘financialization’ is driven by two movements. The first is the growth in the liquidity of capital markets, expressing increases in the breakdown and transfer of risks. The second is the upsurge, in these same markets, of investment funds, responsible for the management of continually increasing savings. Far from remaining limited solely to the financial sphere, these changes have profoundly affected listed companies, the main players in the world economy. In this respect, the ideology of ‘shareholder value’<sup>1</sup> has played and continues to play an essential role. The concept of ‘finance-led capitalism’ can be used to describe this new growth regime, in which a decisive role is given to the profitability of stock market assets, in both the creation and distribution of value added. Our aim here is to grasp the principal moving forces behind this ‘finance-led capitalism’, in other words to understand not only the regularities which maintain its functioning, if not its durability, but also its most widely recognized weaknesses – factors of instability.

To this end, we concentrate on two questions. The first deals with the dynamic induced by the continual expansion of risk transfer in the financial markets. The second explores corporate governance, and the governance of listed companies in particular. The term ‘governance’ covers all the measures, procedures, institutions and practices that determine the exercise of power in firms during a given period. Our hypothesis is that power relations within the firm, which determine the firm’s strategy in different markets (finance, products, labour), have been drastically altered by transformations in the financial sphere. The result is that these relations, formed among the main stakeholders in the firm (shareholders, executives, employees), around the control of the firm, have taken on a new dimension. Whereas the cycles specific to what is generally called ‘Fordism’ found their source in markets, we demonstrate that cycles are now driven from within large corporations.<sup>2</sup> Today, corporate governance is a central institution, through the detailed study of which we can reach an understanding of the current regime.

This book is structured around three questions:

1. What are the consequences, in terms of stability and cyclicity, of the increase in the liquidity of capital markets?
2. What transformations have been induced in corporate governance?
3. How does this governance, in return, influence the dynamic of the growth regime?

The United States constitutes the principal reference in our analysis; it is the country in which the expansion of market finance is most advanced. France and Germany are analysed in counterpoint: the model of capitalism they embody enables us to appreciate fully the transformations currently taking place.

This first chapter gives a stylized presentation of the main facts which will serve as a reference throughout the book. The first section presents a synthesis of transformations that have taken place in the financial sphere. The second section concentrates more succinctly on an essential process in the current dynamic: technical changes connected with the diffusion of information and communication technology (ICT). This presentation is justified by the fact that our analysis will call for numerous detours into ICT issues. The third section underlines the articulation of the two processes, financial and technological.

## THE RISE TO POWER OF MARKET FINANCE

From the end of the Second World War through to the 1970s, corporate governance, though assuming a different form on each side of the Atlantic, nevertheless concurred on one point: the weakness of market mechanisms in general, and of capital market mechanisms in particular.

In the United States, the dominant form was 'managerial capitalism', characterized, in the words of Berle and Means (1932), by the '*separation of ownership and control*'. The wide dispersion of share ownership left executives with a very high level of autonomy in their strategic choices. The absence of controlling interests, linked to a fragmentation of financial institutions that had been initiated before the war (Roe, 1994), meant that direct sensibility to the desires of the shareholders on the part of managers remained illusory. Hostile takeovers were hardly more effective in controlling executives, who formed a 'technostructure' at the top of the biggest firms (Galbraith, 1967). The increase in the number of conglomerates, to satiate the power-hungry executives, was without a doubt the most obvious



symptom of this particular configuration. The level of dividends remained relatively low during the 30 years following the war.

In continental Europe (notably in France and Germany), on the contrary, it was the tightness of capital markets which protected firms from stock market control. The concentration of ownership and the stability of shareholders made managers insensible to capital market logic: profits were massively reinvested – to the detriment of the distribution of dividends – and hostile takeovers were almost inexistent. The highly institutionalized nature of industrial relations (collective agreements in France, co-determination in Germany) also contributed to the independence of firms in relation to the capital markets. In short, internal control, very often family control, prevailed, while few companies were listed on the markets.

A process of liberalization and integration of capital markets was initiated in the mid-1980s, and was to have decisive consequences. This process was accompanied by substantial rises in interest rates, with the hardening of monetary policy and priority given to the fight against inflation on both sides of the Atlantic. Institutional reforms undertaken with the aim of favouring the tradability of securities and the transfer of risks were thus built up within a context globally favourable to creditors (shareholders and lenders). These transfers were facilitated by the creation of new, ever more sophisticated financial products, traded on the new markets.

On the supply side, as on the demand side of financial securities, the trend was very favourable and accelerated during the 1990s. If we concentrate on the stock markets, a first quantitative evaluation is provided by the evolution of the ratio between national market capitalization and GDP (see Table 1.1) for the three countries under consideration.

*Table 1.1 National market capitalization as a percentage of GDP*

	United States	France	Germany
1980	50	8	9
1990	56	26	22
1995	95	32	26
1996	112	38	28
1997	133	48	39
1998	149	68	51
1999	181	111	72
2000	153	112	68
2001	152	103	61

Sources: FIBV, Eurostatistics, Eurostat (August–September 2001) and Van der Elst (2000).

On the securities supply side, the number of listed companies has risen, as have share issues. France is a characteristic case in point: whereas total share issues in 1980 were worth 7.9 billion euros, they reached the value of 33.7 billion euros in 1990, and then 113.7 billion euros in 2000 (Plihon, 2003, p. 55). This process has been boosted by the series of privatizations carried out since the second half of the 1980s.

For a firm, the primary objective of a call for public savings is the transfer of claims: the tradability of securities enables incumbent shareholders who wish to liquidate their stakes to withdraw from the capital (Lazonick and O'Sullivan, 1999; O'Sullivan, 2001). The financing of investments, on the contrary, is rarely the motive for entry onto stock market listings or for the issuance of new securities. This is the conclusion drawn from all the quantitative studies (see for example Rajan and Zingales, 1998): contrary to one persistent belief, the stock market does not serve primarily to finance new investments. It can be used for this purpose, notably in the sector of new technologies (see below), but this only occurs to a small extent. Table 1.2 gives a good illustration of the minor role the market plays in terms of investment, with firms generally preferring other sources of finance (retained earnings, bank loans and bond issues).

Recently, we have seen the emergence of two new functions of capital markets, in addition to the traditional function of stock market calls (the transfer of claims). The new functions bear witness to more strategic uses of these markets. They are performed by the secondary market, with fundraising on the primary market only constituting a preliminary to the daily evaluation of securities. The first of these functions is external growth. Over the last decade, the stock markets have made it possible to finance takeovers, whether friendly or hostile, by means of share exchange offers. Once again, this has been particularly true in the sector of new technologies (see below). Market quotation therefore provides access to a new currency of exchange (shares), whose buying power increases with the price of the share. Capital markets are consequently at the service of an industrial

*Table 1.2 Net percentage of share issues in the total financing of firms for the 1970s and 1980s*

USA (1970–89)	Germany (1971–92)	France (1971–92)
–8.8	0.1	4.3

*Note:* The negative value in the United States is the result of share buy-back programmes carried out during the 1980s, with the principal objective of increasing capital profitability.

*Sources:* Corbett and Jenkinson (1996), Mullineux (1996), quoted in Burkart (1999).