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COLLECTIVE ACTION PROBLEMS IN MONITORING MANAGERS THE ENRON CASE AS A SYSTEMIC PROBLEM

By

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At the core of the Enron disaster lies a problem of considerable conceptual interest and importance: the obstacles to collective action which arise when an agent (in this case the managers) is monitored by many principals (in this case the shareholders) rather than one principal (Lyne and Tierney, 2002). This occurs often in politics and other areas, and deserves some attention not only to understand the problems of corporate governance and the human suffering caused by the Enron failure but also to understand the type of problem more broadly (Shinn and Gourevitch, 2002). In the Enron case, stockholders were taken advantage of by managerial greed, reinforced by the collusion among “reputational intermediaries” who play an important part in the monitoring system.

The Enron case also informs the lively discussions that compare corporate governance systems—the shareholder model of the US and the UK in contrast with the stakeholder model associated with Germany and other countries in continental Europe (Aguilera and Jackson, 2002; Dore, 2000; Lazonick, 2000; Berger and Dore, 1996; La Porta, et. al.2000.) The US model is said to protect the rights of external shareholders from the abuses that can be carried out by “inside owners,” or blockholders common in the stakeholder model. And it appears to do so. But the US model has a vulnerability which arises out of its virtues: the laws that protect external investors create fragmented ownership, which in turn creates a collective action problem: no one has an incentive to pay the transactions costs required to monitor the managers. Fragmented ownership creates the need for external monitors, “reputational intermediaries,” who are essential to the functioning of the system. If these intermediaries (accountants, bond and stock analysts, banks, lawyers) collude, the shareholders are at risk.

These failures bring out the importance of politics in understanding corporate governance and the firm. The behavior of the managers and the reputational intermediaries in the Enron case was enabled by changes in the regulatory system in the US that allowed the erosion of boundaries and obligations in monitoring. Political lobbying played a very visible role in that regulatory development. This provides evidence in the debates about the relationship between politics and other causal arguments.

I. Two Systems: Shareholder vs. Stakeholder Models of Corporate Governance

From the perspective of agency theory, the core problem of the modern corporation lies in the relationship between managers and owners. In a small enterprise, the owner and manager are the same. As the firm becomes large, its tasks require differentiation and its capital needs require investors. The two tendencies create a need for specialization: professional managers, who run the firm, and the investors, who put their money into it. In the limited liability company as modeled by principal/agent theory, “the principals,” the owners, hire managers, “the agents,” to carry out the specialized function of managing the firm. The challenge for the investors is to establish a relationship with the managers that ensures the firm will be run to meet the goals of the owners, rather than be subverted to suit the managers at the expense of the owners—the problem of moral hazard (Coase, 1937; Jensen and Meckling, 1976).

Two models have evolved to solve the problem of linking shareholders to managers. They are generally called the shareholder model and the stakeholder model, though both involve shareholders. While different labels are used, there is convergence in the descriptions of the major features of each (Kester, 1992; Dore, 2001; Hall and Soskice 2001; Iversen and Soskice, 2001, Gourevitch 2001). The differences lie in rights and powers of shareholders, how the shares are held and voted, and in the role of other actors in the economic system of the firm. The shareholder system prevails in the US and the UK, as well as Canada, Australia, New Zealand. Versions of the stakeholder system exist in Japan, Germany, much of Europe, most of Latin America and Asia, with some mixed cases in places like France.

The two models differ in the way they distribute power within the firm and between the firm and its investors. Governance structures shape who can make decisions, who monitors the decision-makers and with what kinds of information and instruments. Discussions of governance often look only at the board of directors, but this is inadequate: the functions of the board are influenced by other elements of the system, many of them outside the firm itself. Shinn (2001) has identified the key features of a governance system as: *information institutions*: accounting rules, audit procedures, standards settings, and third-party analysis; *oversight institutions*: boards of directors and the rules governing their fiduciary responsibilities; *control institutions*: the degree of voice minority shareholders have in case of contested control and the rules which govern such contests, including the rules for hiring, compensating and firing senior managers.

These parameters of corporate control can vary, comprising alternative models of corporate governance. As Kester (1992) phrases it, shareholder systems see the core managerial problem as agency, as controlling moral hazard, to prevent agents from acting away from the goals of the principals, and solve it by stressing the monitoring powers of external shareholders; the stakeholder systems see the core managerial problem in terms of transaction costs, and solve it with strong internal linkages among the components of the firm and its major partners.

The Shareholder Model

The shareholder model’s solution to the moral hazard problem is a system of check and balances, separating out functions, and giving external shareholders a number of rights. The goal is to encourage investment by outsiders. Without protections, external investors are

vulnerable to exploitation by insiders, managers and blockholders alike. Insiders (managers, other shareholders) may not provide or use information that is not available to all. They are obligated to provide a regular flow of information (quarterly reports, annual audits, etc.). Armed with such information, the public shareholders evaluate the managerial performance via the market. Firms that under-perform face the loss of share value from sales (exit) or take-over; a vigorous market for corporate control is a key monitoring instrument.

Shareholder systems have strong anti-trust regulations and strict laws against insider information. Concentration of ownership is limited: pension funds, institutional investors cannot own above a certain percentage limit of a single firm nor have too many of their assets in one firm. Banks cannot own substantial chunks of firms nor name their representatives to firm boards. Cross-shareholding, rotation of managers, tight bonds to suppliers or sellers up and down the supply chain are limited to prevent collusion. (Individuals are not restricted in their percentage ownership; they can perform monitoring functions subject to insider trading rules.)

Managers are monitored by the stock market. Rising and falling share prices indicate performance. “Patient” capital may exist—shareholders that stress value over the long haul and are thus less responsive to short term fluctuations, but these shareholders interact with many whose preferences are more short term. If shareholders (principals) are dissatisfied with their agents, they can sell shares. When share prices fall, the firm becomes vulnerable to take over, friendly or hostile – the market for control, the take over via share purchase, is thus an important way managers are monitored by this system.

The problem in the system lies in the costs of monitoring and fragmentation of ownership. Since stockownership cannot be concentrated, shareholders own small percentages of the whole. Monitoring is costly: knowing what the managers are doing requires gathering and analyzing information: visiting factories, interviewing managers and employees, reading the footnotes of company reports, challenging company statements, in sum, evaluating very carefully what is produced. This is a costly activity. Monitoring thus encounters a collective action problem: no one owns enough of the firm to make it worth their while to pay the costs of monitoring. They face the vulnerability of free riding—other investors can use the information gathered by one or a few.

Instead, shareholders monitor managerial activity through relatively “cheap” (low search cost) information. First, there is the board of directors. These are statutorily responsible. In theory they are elected by the shareholders. They hire and fire, set pay compensation, examine the audits, approve plans. Law requires the firms to have audits and make them public. Strict insider trading rules demand that all information available to the board and managers be made public to all shareholders. This generates a massive amount of information.

In theory, that information is then analyzed by a system of “reputational intermediaries outside the firm—not only external auditors, but stock analysts, investment banks, bond rating agencies, lawyers and others—all private and all with a financial incentive, presumably, to conduct close analyses and provide solid opinions. These players make recommendations and ratings: that the stock is worthy of a purchase or the bond deserves a particular grade of investment according to the risk. Auditors compile annual reports. Rating agencies (like Moody’s, Standard and Poor) evaluate bonds. Banks evaluate credit worthiness. Institutional investors and brokerage firms analyze the stocks and issue ratings of their own. Lawyers

inform what is permissible. The Securities and Exchange Commission (SEC) is the major regulatory body of this system, but it too relies heavily on the reputational intermediaries system. Other regulators are the stock exchange managers who make firms desiring to be listed observe listing requirements, and, in the US, a wide range of state authorities, legislatures, courts, attorneys-general. The system thus monitors managers on the basis of high volume, but relatively shallow information, and provides information in a constant flow of short-term snapshots.

This system does work much of the time. The US and the UK stock markets are the world's most heavily capitalized. Savers and investors in these countries and around the world feel relatively safe investing in stocks and bonds of companies listed on those exchanges because they feel the system protects the external, minority shareholder, while the other systems, the stakeholder model does not, for reasons we will explore below.

What has gone wrong recently? If all the pieces of this system were all completely independent actors, they would indeed be able to provide some kind of significant monitoring. What Enron *et al.* showed was that the independence of these intermediaries has eroded substantially. Instead of providing information to external investors, the intermediaries colluded with managers and each other at the expense of shareholders.

Managers largely pick the board and reward board members for compliance with managers' wishes. This has long been understood: stockholder democracy is a fiction. It is nearly impossible for stockholders to work together to challenge management seriously. Only a firm carrying out a hostile takeover attempt can afford the cost to do so. Consequently, the system turns to the reputational intermediaries. Investors base their buying and selling decisions on the information provided by these intermediaries. If the latter are comprised, the shareholders are vulnerable to abuse.

Audit committees of the board rely on auditing firms. The audit is paid by the firm, not the shareholders. It is thus designed to fit the strategy of the firm, not to provide investors and shareholders with independent information. In recent years, the auditing firms have increasingly derived income by providing consulting services for the very firms they also do the auditing for. This creates a conflict of interest as auditors become reluctant to challenge the firm through an audit when they earn more money from the same firm with consulting. The large institutional investors have developed a similar conflict of interest. Their analysts evaluate and recommend stocks; their investment banking arms make deals with firms, often the very ones the analysts are evaluating. Merrill Lynch has been charged by the state of New York with corruption of these analyses. While the bond rating agencies have a quasi-monopoly and little incentive to rock the boat; they are charged with bias as well. The rating agencies and some of the brokerage firms waited a long time before downgrading Enron. Banks seek business from firms, as do lawyers. Banks made deals with Enron executives that, it is argued, they should have challenged, and lawyers did the same.

Institutional investors own substantial sums, though no individual one has large percentage in order to diversify risk, but they behave as passive investors, they do not challenge management by voting their proxies. Furthermore, they get business from management (the pension funds), a fact which provides yet another reason not to challenge them. CALPIRS (the state of California retirement fund) is an unusual exception to this generalization, as is to some degree TIAA-CREF (the teachers' retirement fund). It is possible that these two

exceptions are linked to the clientele they serve, who are more sympathetic to challenge management.

Another instrument of monitoring managers, the market for corporate control, has also been greatly weakened by managers. These have been able to create defensive instruments like poison pills, special rules for mergers, separate board structures, all of which make hostile takeovers harder—and thus for managers to be monitored effectively.

The official regulator, the SEC, is a relatively small institution. It heavily relies on the reporting system for “fire alarm” monitoring (responding to complaints). It can do “police patrols” (preemptive investigations) when evidence of insider trading appears, but it cannot monitor the whole system of rules. The American system thus depends to a large extent on market mechanisms for enforcement.

The problem now evident to all is that the system has been compromised. All the major players have an interest in colluding at the expense of the external shareholder. During the 1990s, an incentive idea about compensating managers spread widely: providing managers with stock options would align their interests with shareholders, as both would have an interest in seeing share value rise. This turned out to have perverse effects: managers had an interest in driving the price up to realize their gains, invoking their options and then cashing out. They were allowed to count options as an expense in taxation but not as a cost in estimating profits, thereby distorting earnings. This also had the effect of diluting shares: the percentage of firm ownership by top management rose from 2% to over 10%.

The conditions that allowed the compromise of the system were tolerated, allowed and facilitated by regulatory policy. The general drive in the US toward de-regulation applied to this sector as well. The Glass Steagal Act on banking was repealed, interstate banking allowed, regulatory boundaries among activities loosened. The regulatory system has allowed an extensive blurring of boundaries and a set of overlapping and conflicting interests to develop.

To the fragmentation of ownership principals may be added the fragmentation of regulation. The American system is very decentralized. Regulatory functions are scattered among numerous agencies in the federal government. Corporate law is run largely by states, and companies hence do jurisdiction shopping: Delaware opinions shape national regulatory behavior. Supposedly state law could be overridden by federal law (as with the SEC) but that adds a layer to the political complexity of the process (see below).

There are many virtues to the US/UK system. By protecting the interests of external shareholders, it encourages the mobilization of savings through share ownership. The US has much higher stock market capitalization of its firms than do European countries. It is famous for venture capital, for flexibility in the allocation of capital, for getting into new ventures fast, and getting out of declining industries. This is not the place for a comparison of the US with other systems on performance grounds. My purpose rather has been to examine the institutional vulnerability of the US system. At the core of this vulnerability is the problem of collective action that arises in a system of a plural principal: the shareholders are numerous and thus have a collective action problem. This issue can be sharpened by comparing the shareholder model to its most well known alternative, and in turn, to look at its characteristic weakness.

The Stakeholder Model

The stakeholder model can be characterized as solving a different problem than the shareholder model. Rather than moral hazard from autonomous managerial agents, the stakeholder model stresses, as Kester (1996) puts it, the problem of transaction costs. The shareholder system requires arms length relationships among all the players in the production system—subcontractors, banks, labor, etc. It thus inhibits a certain kind of information sharing and cooperation. The stakeholder model lowers the transaction costs by allowing substantial interaction among all the players through shared ownership and control. The price it pays is higher agency costs for external shareholders and thus disincentives for maximizing shareholder value and the returns to investors.

The stakeholder system is characterized by “blockholders,” the owners of large blocks of shares, concentrated in a few hands that do not trade. Other stakeholders, workers, suppliers, sellers, the participants in a productive system have more voice than is the case with the shareholding system. The most notable example is the German system of codetermination with worker representatives on boards. Local and state governments are also big shareholders. Another distinct feature of this system is cross-shareholding where firms may own blocks of each others’ shares, or shares among its suppliers. These firms exchange personnel and share substantial information.

In many cases, these blockholders are families, sometimes cohesive ethnic groups (as in the hua-quia “bamboo networks” of Chinese family-owned conglomerates in East Asia), where bonds of blood and cultural affinity link the members of a network together. In some cases, such as Japan, blockholding systems are sufficiently complicated such that there is ultimately neither a controlling individual or family owner of many firms nor any control exercisable by outside shareholders resulting in firms that are effectively controlled by the managers themselves. But even in Europe, a very high percentage of firms are family owned or controlled.

These systems may reflect cultural values but these values are backed up quite strongly by rules, regulations and regulatory institutions. Laws allow concentration of ownership and cross shareholding and may even reward it. For example, in the past, German law taxed share sales by firms quite heavily, which deterred sales; yet in an attempt to break up the system of cross-shareholding by German corporations, the government has eliminated that tax recently. Anti trust is weak in law and/or poorly enforced. Securities regulation does not punish insider information. In the stakeholder system, manufacturing is buffered by over-investing in capital stock or other protections from disruption. This has been called buffered manufacturing, rather than “lean production.”

Indeed, insider information is the essence of the system. Its advantages lie with the incentive to share information. In the shareholder system, manufacturers and suppliers maneuver around their conflict of interest: being taken advantage of by paying too much or too little, they have every incentive to conceal information and not to invest too far in the specific assets of each other’s business. The stakeholder system encourages information sharing because the economic fates of the firms are tied together. Extensive cross-shareholding and other coordination mechanisms prevent the opportunism that sharing of information may otherwise provoke.

Creditors sit on the boards of firms in the stakeholder system. As major long-term shareholders they have incentives to pay the costs of substantial information, rather than to rely on cheap information indicators. Managers have incentives to share information fully with their blockholders. Fights for corporate control are rare, as are anti trust suits and insider trading cases. Stocks are held for very long periods. Firms are able to invest in long-term relationships and share extensive information.

These features of information sharing and long term relationships seem to produce distinctive economic features among the firms. The firms in such a system have an economic incentive to invest heavily in specific assets rather than general assets. Shareholder model firms invest in general assets, in machines and relationships that can be changed or abandoned in response to market pressures. The specific assets approach seems to encourage modernizing existing industries and improving on manufacturing systems. Germany and Japan are both famous for quality engineering and manufacturing. This appears to derive from their incentives to invest substantially in the specific assets that correlate with excellence in these activities. Conversely, shareholder systems may have more flexibility in globalizing production. American firms in the computer hard disk drive industry moved early to learn the techniques of disaggregating the components of a product, scattering their production to the most advantageous site, and making final assembly again in an appropriate location (Gourevitch et al, 2000; McKendrick et al., 2001). Stakeholder firms have had more difficulty doing this.

The disadvantage of the stakeholder system lies in over-investment in existing sectors and under-investing in radically new technologies and processes. Venture capital systems are weak. Capital is generated from within each network, but is then limited in its allocation to the interests of that network. The managers and their allies promote growth of firm size, not the value of the shares, or the paying of dividends. At times this generates productivity in quality processes; at other times, when technological change is rapid these systems pay a price for that advantage

II. Monitoring Issues—Correcting Incentives

The two systems thus handle differently the problem of principal-agent relations connecting shareholders to managers. The shareholder model leads to fragmented ownership but yields an aggregation of agents. A collective principal, the shareholders, have to monitor the manager. The American firm is fairly authoritarian – the chief executive officer (CEO) has a lot of power, especially if he is also chairman of the board, which many of them are (another blurring of interests). Fragmentation of ownership poses a collective action problem: how to mobilize the principals to monitor the agents? Mobilizing shareholders is costly, and thus quite rare. The recent proxy battle between the CEO of HP and one of its major shareholders (a member of the founding family) over the Compaq merger proves the point: it is a rare event, made possible in this case by private wealth. The principals here are a fragmented collective: the shareholders collectively are the principal (thus it is not a case of multiple principals, where the agent would have separate contracts with several principals) but of many members within a single principal (Lyne and Tierney, 2002).

For almost all such shareholders, “voice” is costly, “exit” far easier (Hirschman, 1970). For analyzing exit, the system of reputational intermediaries is vital. The accountant’s report is fundamental. It provides the information for all other actors—analysts, bond rating agencies,

individual investors—who make decisions on buying or selling. Flawed accounting compromises the base of this process. The reputational intermediaries could in theory probe the reports, read the footnotes, ask questions, investigate. If they in turn are compromised, external shareholders have little protection.

The stakeholder system solves the collective action problem among the principals by allowing concentrated ownership of shares. As substantial shareholders they have strong incentive to pay monitoring costs as they know they will be listened to and their risk is greater. They become insiders, and as such are able to share information with managers. They can communicate many things like long-range strategy, technology, whatever, without fear of having to make public what they see as proprietary information. The stakeholders can thus become patient capital, because they are not passive capital. . The insider model allows managers and owners to retain capital and use it for a steady flow of investment in the firm's core activities, somewhat free of business cycle fluctuations, with long-term perspectives. The stability of the system allows firms to invest in "specific assets", in technology and labor relations which favor manufacturing skills (Hall and Soskice, 2001). This advantage does not come without a cost, a cost paid by the external shareholder. They have no protection in this system. Managers don't worry about share prices. Many things can be done at the expense of the poorly protected external shareholder. External investors are thus cautious about entering these systems. Share capitalization is low. The retention of earnings and investment causes what has been termed "the agency costs of free cash flow" (Jensen, 1986), the ability of managers to resist market cues on rates of return. This leads to over-investment in declining sectors. Ten years ago, when Germany and Japan were doing well and the US showing problems in adjusting to trade pressures, that capacity for steady investment was seen as an advantage by some stakeholder proponents, who argued that it had lower transaction costs, rewarded long term relationships, and encouraged the sharing of information. The American model was criticized as too oriented to the short term and not able to sustain long-range product development and improvement (Porter, 1992).

Workers may well like this system, as do communities, because they have greater protection of jobs and location. On the other hand, to the extent employees become the owners of pension funds, their incentives become cross-pressured. In the US, the rise of corporate and individual retirement funds has been very pronounced. This has been a major source of the funds which are then being invested in the US and overseas. Employees and salaried people thus acquire an ever larger stake in the securities markets. This may make them more aware of issues concerning the way it is governed. This has also been a major issue in the Enron case for example, where employees were unable to sell their shares while managers could. Regulation is thus likely to increase as an issue across the political spectrum and to create more complex political evaluations.

Designing Corporate Governance Institutions

Can the US system design institutions to prevent further occurrences of cases like the Enron case? Several things can be done—whether they will be is another question, requiring a different analysis of the politics of it all, which I explore elsewhere (Gourevitch, 2002)

A. Strengthen the system of reputational intermediaries. An important change would be to prevent the kind of collusion that has taken place. This has attracted the most attention in

American discussions, where the criticism of Andersen has been more intense at times than even that toward the Enron managers. Many bills have been proposed in the US Congress which seeks to create greater separation among the components of the reputational system: prevent accounting firms from simultaneously offering accounting and consulting services; require boards to have the audit committee be truly independent; rules on brokerage firms and advice giving; rules on pension funds, etc. Separating functions, more disclosure: these can have some impact. To my knowledge, the most interesting idea has not become a target of legislation: someone proposed in the NY Times to obligate companies to buy insurance for their audits, and then to empower the insurance companies to do the audits. Insurance companies would build the price into the insurance premiums, and would have a strong incentive to do a good, and independent, job.

B. Restore the market for corporate control: Legislation and regulation could forbid poison pills and a lot of other moves to squash the market for control. The takeover code of the City of London for example is much more supportive of shareholder pressures on managers.

C. Separate the managers from their boards: It is widely understood that many if not most boards are dominated by the managers, so that the agents can manipulate the principals. To correct this, it has been suggested that boards be compelled to have more “outsiders”, that the audit and executive compensation committees in particular be separated from the managers, that the office of president (COO) and chairman of the board be separated.

D. Motivate monitoring: None of these measures (separating the reputational intermediaries, strengthening the market for corporate control, regulating the composition of boards) will get at the collective action problem caused by fragmented principals and fragmented reputational monitors. This could only be handled by identifying actors with a large enough stake to make it worth their while to undertake the costs of thorough monitoring. In the US system, this could only be the big pension funds and other institutional investors as they do own large blocks of stock. At present, they are passive in their use of this ownership, as they appear reluctant to create conflicts with management. Their incentives could be changed by regulation. They could, for example, be forced to report on how they have voted their shares, to provide criteria explaining how they judge governance, or how they have scrutinized information given by firms. Institutions should be obliged to publicly disclose their corporate governance policies for firms in which they invest and, more important, their proxy voting records on these firms, at home and abroad. Similar rules have been proposed by the Myners Commission in the United Kingdom. Indeed, currently the Department of Labor (DOL) and SEC require mutual and pension funds to disclose their asset risk profiles and other performance data. Why not require disclosure of their performance on corporate governance as well (Shinn and Gourevitch 2002)? Institutional investors do not seem very enthusiastic about being given this task. They themselves appear to worry about agency problems: how to define their obligations to be clear as to what standard of monitoring firms they are obligated to follow? Just what would their principals (the people that place their money with them) want them to do? Their concern is compounded by problems of measurement. There is no agreement on how to measure good governance. For instance, criteria about board composition would have rated Enron just fine in terms of its corporate governance performance standards. Another way to motivate supervision would be to allow institutional investors to own larger percentages of shares in any given firm, though this would undermine the concern for risk diversification.

The problem for the US is how to create motivated shareholders without encouraging insider trading at the same time. Conversely, the problem for the stakeholder model is how to protect external investors without destroying the advantages of shared information among the stakeholders. Can the systems be blended? Or are these really deeply different logics, so you are on one side or another, with no intermediate equilibrium? As the Americans now face debate over changing the rules, in Europe and Japan there have been some efforts to change. Germany repealed the tax on capital gains of firms' share sales, which observers predict would lead to unwinding of the cross-shareholding that has been a key buffer in the system. Those fearful of too much change then passed legislation making hostile takeovers more difficult. The equilibria in question are political.

III. Political Foundations of Change and Preservation

The systems of corporate governance rest on politics. Firms comply with rules and regulations set and enforced by governments. Law certainly has a strong influence on firms, as it is law which sets the rules and regulations (La Porta, Schleifer et al., 2000). But law is formed by politics (Roe, 2001). The rules on insider trading, accounting obligations, anti trust, the market for control, the obligations of directors, the status of labor in shared governance all come from authoritative decisions made by governments. In democracies that means they come from politics and political processes.

This was very evident in the Enron case. Accounting firms in the US lobbied via Congress to block the SEC from issuing regulations that would force the separation of consulting and accounting (*New Yorker*, April 2002). Lobbying over many years produced the loosening of the regulatory boundaries that separated various pieces of the reputational system from each other. Lobbying creates the fragmented regulatory system that governs American finance.

Roe (2001) stresses the role of politics in shaping divergence among governance systems. His major explanatory variable is social democracy: where labor is strong, the blockholder system prevails. Roe is correct on the importance of politics, but incomplete in his interpretation of the causal mechanisms. Labor has strong support in defending the system from other actors: existing blockholders, who are politically not social democratic, resist quite strongly any changes that would threaten their control of the firm and the privileged position of their ownership shares. (Shinn, 2001, Shinn and Gourevitch, 2002).

The embeddedness of governance systems in broader social processes (Aguilera and Jackson, 2002) also influences the politics of regulations in ways which do not fit a left /right dichotomy of strong vs. weak labor. Governance interacts with other subsystems (Hall and Soskice, 2001). These systems reinforce each other. Stakeholder corporate governance is associated with centralized labor markets, extensive firm centered apprenticed training, centralized price setting, extensive business associations, and extensive social welfare systems, in Germany centered on firms. These interact to encourage investment by firms in specific assets which in turn induces a broad coalition to defend the system. These interaction effects would have to be unbundled to alter the politics, and that would take quite a bit of structural change.

A stronger political argument focuses on two variables: political institutions and interest groups. Political institutions structure interest aggregation, the way in which the preferences

of individuals and groups in society are translated into policy outputs. The political systems of industrial democracies vary in ways that influence the rules and regulations concerning corporate governance. Majoritarian systems (single member districts with two party systems in a parliamentary or presidential system) magnify the consequences of a vote shift. A small shift of vote can thus produce substantial policy swings. The consensus systems have proportional representation, several political parties, and coalition governments. Small shifts in votes are not magnified in representation and all players have a say in whatever happens. Policy swings are modest. Majoritarian systems prevail in the UK, the US, Canada, Australia. Consensus systems prevail in Germany, Japan, Scandinavia (Gourevitch and Hawes 2001).

The variation in political institutions thus corresponds to the variation in governance structures. The shareholder systems predominate where there are majoritarian institutions, while the stakeholder systems prevail where there are consensus systems. There is a logic to this: actors in stakeholder systems seek stability of policy in order to preserve their heavy investment in specific assets. The coalition model is thus a form of insurance against a shift away from the market regulating policies in which these investments make sense. Conversely, actors in shareholder systems that have majoritarian institutions have the incentives to invest in general assets whose use can be shifted more easily; swings in policy discourage investment in specific assets.

In comparison to an institutionalist argument, an interest group interpretation stresses the preferences of social and economic actors for certain policy approaches. Roe's argument lies in this category: labor dislikes the shareholder model, he argues, therefore the stakeholder model prevails where Social Democracy is strong. The Hall/Soskice discussions present the cleavages differently: managers and investors may also prefer the stakeholder regulated system because they have invested so heavily in it. They find advantages in the system of worker training, labor market stability, price management and other features of the model in which they have a particular niche. Welfare systems help stabilize the market for skilled workers. Shinn (2001) notes that major investors in the stakeholder system do not want to change either; their privileged position and security of control provides benefits they do not wish to lose.

Arguments of both kinds, institutionalist and interest group, thus stress current politics. Both assume a historical evolution, a path dependence that brings the structure of incentives, both institutional and interest, to the present. An historical argument is also necessary in order to understand how systems emerge in the first place. The strongest version is that of Gershenkron (1962): late developers tend toward the stakeholder model, early developers toward the shareholder type.

In the political debates over corporate governance, international factors add an important dimension. There is little formal control of international governance at an international level. There have been efforts to standardize: the OECD has a corporate governance code, the EU seeks to create uniform standards for many issues. These have had only limited success, as they are unable to overcome the strongly different preferences of the different countries. This remains an area of potential rather than realized importance.

The future evolution of corporate governance rules lies in the interaction of politics with institutions, interests and ideas largely within countries. Change is unusual: the US is one of the few cases which began in one category, the stakeholder, and shifted to the other. Many

observers think the march of history lies with the shareholder model and that European countries will be unable to resist. This is far from obvious. Convergence models assume that economic pressure is unidirectional: competition favors only one way of doing things. It is more likely that economic competition rewards differences. Corporate governance is one aspect of managerial and economic strategies. Different national production systems are a form of specialization. They reward some behaviors and punish others. So long as there is demand for the special products the stakeholder model seems to be good at, so long as it remains superior in this regard to the shareholder model, differences in corporate governance will persist (Gourevitch 2001).

Market forces are not the sole determinants of policy outcomes. Efficiency interacts with other variables like stability, equality, employment and tradition. Corporate governance regulation passes through politics. As political processes vary, we are likely to see important differences in corporate governance forms for some time to come. There will be changes, but it is not clear that these will result in convergence rather than in the modernization of alternative models.

Politics will matter not only at the national level but at the international level as well. International institutions are being drawn into the regulatory discussions, but so far without clear agreements. Thus the future remains fluid, and therefore interesting.

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