Firm Control

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This is the text of an inaugural lecture delivered to the University of Oxford on 18 February, 1999. It draws on work that I have done with several people over a long period of time, most notably Wendy Carlin, Jenny Corbett, Jeremy Edwards, Julian Franks and Tim Jenkinson. The paper also makes reference to results from work with Marco Becht and other members of the European Corporate Governance Network.

Abstract

Why are there such pronounced differences in patterns of ownership and control of corporations across countries? This paper proposes that these, together with many of the stylized facts of corporate finance, can be explained by private benefits. Private benefits create waste and inefficiency but they can also act as powerful commitment devices that overcome capital market failures. The paper argues that the evolution of institutional arrangements in different countries has been determined by political and regulatory interventions which, in turn, have affected the balance between public and private benefits of control. The paper calls for an evaluation of the relationship between institutional design and corporate activity and for a debate on the public policy choices affecting this design.

In heaven, the policemen are English, the cooks are French, the mechanics are German, the lovers are Italian and it is all organized by the Swiss. In hell, the cooks are English, the policemen are German, the mechanics are French, the lovers are Swiss and it is all organized by the Italians. The point of this is not to insult everyone here but to illustrate one of the themes of today's lecture – the relation between national characteristics and economic activity.

12 years ago, I gave an inaugural lecture entitled "New issues in corporate finance" in which I argued that the stereotypical views of corporate finance were wrong.[1] In particular, I proposed a system of comparing corporate finance in different countries that revealed some stark features. The first and perhaps the most striking was the overwhelming dominance of retained earnings, accounting for, for example, nearly all of investment expenditure in the UK and US. The second was the insignificance of stock markets as sources of finance for industry, including countries such as the UK and US with large well developed stock markets. In aggregate, the UK and US stock markets contribute virtually nothing to total sources of finance of industry. If anything, a higher proportion of external equity finance is raised in France and Germany with their minuscule domestic stock markets than in the UK and US. To the extent that companies do raise finance externally, they do so primarily from banks.

There is now a large literature on international comparisons of corporate finance and the analysis that I reported has been replicated on most developed countries and a large number of developing countries. They are remarkably consistent across countries. In the lecture, I argued that these observations pointed to the importance of commitment and relations between firms and investors, in particular between banks and firms. There is now an emerging literature on commitment and relationship banking.

Six years ago, I gave an inaugural lecture at Warwick University. I should say that I do not make a habit of these and I have no more planned. In that lecture, I took up another theme of international comparisons and pointed to the remarkable differences in ownership of companies that exist across countries.[2] In particular, I noted that there are striking differences in concentration of ownership. The figure that I quoted in that lecture was that in 80% of the top 170 firms quoted on the French and German stock exchanges there is a single shareholder who owns more than 25% of shares. In the UK, in only 16%

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[1] Mayer, C. (1988), "New issues in corporate finance", *European Economic Review*, 32, 1167-89.

[2] See J. Franks and C. Mayer (1995), "Ownership and control" in H. Siebert (ed), *Trends in Business Organization*, Tubingen: JCB Mohr, reprinted in *The New Palgrave Dictionary of Economics and the Law,* London: Macmillan, 1998.

of the top 170 quoted companies is there a single shareholder owning more than 25% of shares. In the US, the figure is similar to the UK.

There have now been several studies that have looked at patterns of ownership in different countries. Concentration of ownership is strikingly higher on the Continent of Europe and in the Far East than it is in the UK and US. It is primarily associated with ownership by families and other companies. Banks are not particularly prominent in the ownership of firms in most countries and the degree of ownership by the state varies quite considerably across countries.

In a nutshell, that is what we know about differences in corporate finance and ownership across countries. Today I want to introduce a third puzzle – corporate control. I will begin by describing the facts and the theories that currently exist to explain them. I will describe the deficiencies of these theories and the way in which they should be developed to explain the puzzles about corporate finance as well as corporate control. I will discuss the relevance of the theories for institutional structures and corporate activities in different countries. Finally, I will consider the way in which different systems have evolved and the implications of this for business and economic policy.

1 Corporate control

The results that I am going to present here draw heavily on an international comparison of corporate governance in nine different European countries which is being undertaken by a team of economists (the European Corporate Governance Network). The question that the network has been asking is who owns and controls corporate Europe. The full answer will have to await publication of a book under this title later this year.

It is only over the last few years that it has been possible to undertake an analysis of corporate control in Europe. In 1988, the European Commission passed a Transparency Directive[3] requiring member states to introduce laws forcing disclosure of shareholdings of companies listed on member state exchanges. These laws were gradually enacted during the 1990's and it is only recently that a comprehensive picture has begun to emerge. The Directive requires companies to notify the relevant authorities when voting rights cross certain thresholds of, for example, 10%, 20% of total votes. It therefore relates to control rather than ownership of firms.

[3] Large Holdings Directive, 88/627/EEC

This slide (Figure 1) records the proportion of votes controlled by the largest investor in seven countries. It shows that the average of the largest voting block varies between 34% in Spain and 52% in Austria. In contrast, in the UK, the median size of the largest block is just 10% and in the US it is below the minimum disclosure level of 5%. Concentration of control is appreciably greater on the Continent than in the UK or US.

The picture looks very different when one goes down to the second largest shareholdings (Figure 2). The median size is zero in most countries so that in this figure I report the means, which are greater than the medians; even then they are small. The average size of the third or fourth voting blocks is negligible from a control perspective. Control is therefore concentrated on the Continent not only because of the existence of large blockholders but also because of the absence of other voting blocks.

The one country where second and third voting blocks are not insignificant and indeed not that much smaller than the largest voting blocks is the UK (Figure 3). Even beyond the tenth largest shareholding, the mean voting block is greater than 3%. No individual investor therefore exerts dominant control; instead it can only come from coalitions of investors.

Not only does the scale of corporate control differ appreciably across countries but so too do the parties who exert it. This slide shows the number of reported blocks owned by different classes of investors in UK companies (Figure 4). As is well known, financial institutions, pension funds and life insurance companies are the dominant class of shareholders. Contrast that with the picture for Germany (Figure 5) where families and individuals dominate, non-financial companies come second and financial institutions are third. Similarly in Austria (Figure 6), a majority of voting blocks are held by families and firms, including a substantial number of foreign firms.

The holdings by firms are particularly interesting, and, as this slide indicates, complicated (Figure 7). It is a map of the holdings of Fiat. It shows:

- direct holdings of 22% by a listed company IFI controlled by Giovanni Agnelli
- indirect holdings of a further 12% via IFIL which is in turn controlled by IFI
- a further 8% held by financial institutions that have voting pacts with IFI
- cross-shareholdings between companies controlled by IFIL
- subsidiaries of Fiat which themselves are listed on the Italian stock exchange

Giovanni Agnelli therefore controls a voting block of 42% in Fiat through direct holdings, holding companies and voting pacts with other investors. Fiat in turn controls several other firms listed on Italian stock exchanges.

This slide (Figure 8) shows how Paul Desmarais and Baron Albert Frére together control or have minority holdings in a vast array of the largest Belgian and French corporations including Paribas, Petrofina and Suez. They do it through a holding company called Pargesa Holdings, which is a Swiss company controlled via a pyramid of intermediate companies. Paul Desmarais' pyramid is illustrated in this slide (Figure 9). He controls Gelco Enterprises, which has 64.7% of the votes in Power Corporation of Canada, which has 67.7% of the votes in Power Financial Corporation, which has 50% of the votes in Parjointco, which has 62.4% of the votes in Pargesa Holdings. In other words at every point in the hierarchy down to Parjointco, Paul Desmarais has complete control and at Parjointco, he splits it equally with Albert Frére.

This might seem like controlling companies by Chinese whispers and indeed it has many of their characteristics. But it has a still more striking feature. While Paul Desmarais' company Gelco has joint control of Pargesa Holdings with Albert Frére, it only receives 5.6% of its earnings. This comes from the observation that while Gelco has majority control, it has a claim on only 30.5% of Power Corporation's cash flows, which in turn has a claim on 67.7% of Power Financial Corporation's cash flows, which in turn has a claim on 50% of Parjointco's cash flows etc. Paul Desmarais' company therefore receives just 0.305x0.677x0.50x0.545 = 0.056 of the earnings of Pargesa Holdings. However, before you start passing the hat round for Paul Desmarais, you should be aware of the fact that in 1997, Pargesa Holdings' earnings amounted to CHF 730 million, so that his company was earning around CHF 40 million from this source alone.

The reason why Desmarais' claim on Pargesa's earnings is so modest is that at each point in the hierarchy he shares them with outside investors. Why does he do this? Not I am afraid as an act of generosity but to bring in outside capital and to reduce the cost of his investment. As a consequence, Fiat and Pargesa, and indeed a large proportion of the largest Continental European corporations, are owned by a small number of individuals who exert an immense amount of power but derive little direct financial benefit.

The contrast with the UK and US could not be greater. There, corporations are owned by a large number of predominantly institutional investors, which typically have shareholdings of less than 5%. Between them, they receive all corporate earnings but individually they have little direct control.

2 Principal-agent relations

The principal-agent problem of aligning interests of owners and managers has been resolved in diametrically opposite ways in Continental European and Anglo-American systems. The principal-agent problem is concerned with how one should trade off the incentive benefits of giving managers large shareholdings in their companies as against the risk sharing benefits of spreading shareholdings amongst a large number of investors. The answer in the UK and US has been to spread shareholdings amongst a large number of outside shareholders. Berle and Means pointed in the 1930s to the separation of ownership and control to which these dispersed shareholdings gave rise in the US. On the Continent, there is a similar separation of ownership and control but in exactly the opposite direction: control is highly concentrated in the hands of a small number of investors who have few financial claims on their firms. The principal-agent problem of companies operating in the same industries has therefore given rise to precisely opposite outcomes in different countries: in Continental Europe there is control without ownership of earnings, and in the UK and the US there is ownership of earnings without control.

The fact that there are such divergent solutions to the principal-agent problem in different countries would appear to cast serious doubt over its validity. Why should a trade-off between risk sharing and incentives be resolved in such different ways in different countries? Faced with a threat to theory, the first reaction of economists is naturally to doubt the evidence. As one eminent theoretical economist said "I do not trust anything that works in practice unless it works in theory". However, the evidence here is difficult to refute and actually there is probably no need for this because concentration of control in the hands of a few investors who have little direct financial interest can be justified if they derive other benefits – what economists term "private benefits".

3 Private benefits

In developed economies, private benefits evoke images of empire building, expense accounts and extravagance. They will be familiar to aficionados of airport books, such as "Liar's Poker", in which Michael Lewis describes how John Gutfreund, the chairman of Salomon Brothers, pursued his ambitions of achieving global domination.[4] In November

[4] His wife, Susan, "insisted on having a twenty-two foot Douglas fir as a Christmas tree. When the tree proved too large for the building's elevator, she had a crane positioned on the roof and had it winched up – without, unfortunately, having obtained permission of the penthouse tenants." Burrough, B. and J. Helyar (1990), *Barbarians at the Gate*, London: Arrow, p 276.

1986, a year ahead of the stock market crash of October 1987, Salomon Brothers opened a new trading floor in Victoria in London, twice the size of the one in New York and nearly the size of the station immediately below it. Such was the vastness of the trading floor that employees used to pass footballs "unconstrained in any direction by space….What little energy we generated was dissipated in the rafters. The silence made us feel lazy and enabled people to hide." [5]

The pursuit of global dominance is reminiscent of Émile Zola's parody, some 100 years earlier in his novel "Money", of the creation and destruction of the great industrial bank, Credit Mobilier. The founder and president, Aristide Saccard establishes the Universal Bank to finance projects in the Near East. The crowning one involves having "the Pope himself enthroned in the Holy Land, dominating the world, and assured of a royal budget, thanks to the creation of the Treasury of the Holy Sepulchre", financed by the Universal Bank.[6]

Expense accounts and extravagance feature prominently in "Barbarians at the Gate" which describes the running of RJR Nabisco, a subject of the major leveraged buy-out (LBO) wave in the US in the 1980s. RJR Nabisco kept a fleet of planes, "the RJR Air Force", to ferry its President and Chief Executive, Ross Johnson, and his associates, known as "the Merry Men". On one occasion it was used to fly Ross Johnson's German shepherd out of state to escape the law after it had bitten a security guard. RJR Nabisco also employed "Team Nabisco" which comprised the stars of the US golf world, including Jack Nicklaus (known as "the bear") who was paid a $1 million a year but "growled at doing more than half a dozen appearances".[7] Ross Johnson's philosophy was that "a few million dollars is lost in the sands of time".[8]

My first assertion, and these are no more than assertions is that:

Assertion 1: Private benefits are extensive and explain differences in control-ownership relations across countries

There are reasons for believing that private benefits might differ across countries. What in countries with well developed legal and regulatory systems takes the form of empires,

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[5] Lewis, M. (1990), *Liar's Poker*, Harmondsworth: Penguin, p 199.
[6] Zola, E. (1891), *Money*, Stroud: Alan Sutton, (reprinted 1991), p 113.
[7] Burrough, B. and J. Helyar, ibid., p 130.
[8] Burrough, B. and J. Helyar, ibid., p 131.

expenses and extravagance deteriorates in countries with poorly developed systems into cronyism, corruption and crime. The income of organized protection rackets in Russia – the Mafia – is estimated to be somewhere in the range of 25 to 40% of Russian GNP.[9] But even within the developed country context, there may be significant variations in the scale of private benefits.

To take an obvious example, trading on the UK and US stock market economies is subject to extensive regulation of insider trading. At least until recently, trading on German stock markets was not. The potential for insiders (managers, directors) to exploit privileged information to their own advantage has been appreciably greater on German than on UK and US stock markets. In the UK and US, institutional investors express disquiet at the prospect of being party to private information that has not been publicly disclosed. To be party to such information makes them insiders which disqualifies them from trading securities. To suggest that the concentrated owners on the Continent should not be party to privileged information would be both implausible and undesirable. A significant advantage of having dominant owners is that they have more incentive to provide active corporate governance through monitoring and control than small investors. Whether through their own or related transactions, that information and control confers considerable potential on large investors in Germany to derive private benefits. Similarly, high rates of corporation tax in Germany may encourage dissipation of earnings through expenses and extravagance.

There may therefore be institutional and cultural reasons why private benefits are higher on the Continent than in the UK and the US. But if that were indeed the case it would raise one serious difficulty. In the presence of significantly higher private benefits, the economic performance of Continental European economies should have been markedly worse than that of the UK. At best they should have been subject to more empires, expenses, extravagance or worse to more cronyism, corruption and crime. Anyone who follows league tables of economic performance or just walks round the streets of Barcelona, Birmingham and Bonn can appreciate the problem with this thesis.

In the principal-agent model, private benefits are viewed as creating wedges between shareholder and managers' interests, which are at best diversionary and at worst distortionary. They reward managers without enhancing or by reducing shareholder returns. Ross Johnson wasted shareholder earnings on RJR Air Force and Team Nabisco. John Gutfreund orchestrated lavish expenditures on corporate buildings: "I

[9] Williams, P. (1997), *Russian Organized Crime: The New Threat*, Cass.

suppose we paid for this, didn't we?" one incredulous investor asked Michael Lewis on seeing the Victoria trading floor. Emile Zola's story of the Universal Bank is one of pursuit of wildly fanciful and ultimately disastrous schemes.

But a private benefit does not necessarily involve either wealth transfer or destruction. Far from being exorbitantly expensive, the promotion and protection of family names do not involve investor expenditures. They do not directly benefit investors but they may encourage actions and activities that indirectly do so. That brings me on to my second assertion and that is that private benefits can be a force for good as well as ill.

Assertion 2: There are substantial social benefits as well as costs associated with private benefits.

In 1863, Werner Siemens wrote to his brother, Carl, of his long-standing ambition to "build up an enterprise which will last, which may perhaps one day under the leadership of our boys become an enterprise of world renown like that of the Rothschilds and make our name known and respected in many lands…..For this great plan the individual, if he regards the plan as good, should be prepared to make sacrifices."[10] 136 years later, Siemens AG would appear to have fulfilled Werner Siemens' ambitions.

The desire to perpetuate our names is a powerful one. We might love our daughters but in many societies it is the sons that perpetuate names. There is one society in which the role of the male is particularly important and there is one family in which that role has had a particularly powerful effect. The will of the founding father could scarcely have been clearer:

"I hereby decree and therefore wish that my daughters and sons-in-law and their heirs have no share in the capital of the firm…….Rather, the said firm shall exclusively belong to and be owned by my sons."[11]

His last commandment to one of his sons was his most powerful: "keep your brothers together and you will become the richest people in Germany". The biblical overtones were no coincidence but their effect was more enduring than it had been for many of his

[10] Matschoss, C. (ed.), *Ein Kurzgefaßtes Lebensbild nebst einer Auswahl seiner Briefe*, Vol. 1, Berlin, p 218, quoted in J. Kocka, "The entrepreneur, the family and capitalism: Some examples from the early phases of industrialization in Germany", p 73.

[11] Ferguson, N. (1998), *The World's Banker: The History of the House of Rothschild,* London, Weidenfeld and Nicolson, p. 79.

forefathers. "Never has a father's last testament been carried out more conscientiously and more profitably…..Since his death, any proposal, no matter where it comes from, is the object of collective discussion; each operation, even it is of minor importance, is carried out according to an agreed plan and with their combined efforts."[12] The father was Mayer Amschel Rothschild, and his offspring were his ten surviving Rothschilds - five of whom were male.

We put up headstones, we endow fellowships, we establish foundations to perpetuate our names. Patrick Geary describes in "Phantoms of Remembrance" how 11th century Benedictine monasteries took over the role played by women of preserving family memories by reinterpreting histories in a form that was consistent with current needs and views.[13]

It is not just the desire to perpetuate names that promotes entrepreneurship. In 1837 George Peabody moved from Danvers, Massachusetts to London to set up a merchant bank at 31 Moorgate. He arrived a few years before five American states defaulted on their loans and during a period when British investors treated American finances with derision. But George Peabody flaunted his Americanism and declared that George Peabody and Company would be "an American house with an American atmosphere – to furnish it with American journals – to make it a centre for American news, and an agreeable place for my American friends visiting London".[14] When Peabody died in 1869, the British government dug a grave for him in Westminster Abbey, but his deathbed words, "Danvers – Danvers, don't forget" deprived London of his remains. This was after he had refused his successor, Junius Morgan, the right to use his name. His institution instead rose to become one of the most illustrious names of banking, J.P. Morgan.

The significance of private benefits as a power for good should not be unfamiliar to academics. We might do our job for love but we certainly do not do it for much money. Recognition, honour, prestige are almost certainly more powerful influences than performance related pay. So long as Oxford University can sustain the kudos of being a member of an exclusive club, it has a remarkably cheap mechanism for maintaining its operations. But when others of similar prestige start offering material as well as spiritual

[12] Friedrich von Gentz, quoted in Ferguson, ibid, p. 84.
[13] Geary, P. (1994), *Phantoms of Remembrance: Memory and Oblivion at the End of the First Millenium,* Princeton: Princeton University Press.
[14] Chernow, R. (1990), *The House of Morgan: The Secret History of Money and Power,* London: Simon and Schuster, p. 5.

happiness then a failure to match is doubly dehabilitating: the club membership as well as the financial rewards are gradually eroded and what starts as a trickle suddenly becomes a flood.

4 Institutional design

Desires to enhance family names and to pass on enterprises to offspring are powerful incentives to enterprise formation. But they also have their deficiencies. Alfred Chandler developed a thesis of comparative industrial performance around differences between managerial capitalism in North America and family organizations in Europe.[15] He argued that Europe, in particular the UK, was held back at the turn of the century by a continuing reliance on family as against professional managerial capitalism. Successes were restricted to industries in which there were modest investment requirements, most notably branded packaged goods in the case of the UK. Companies such as Beechams, Cadbury, Colman, Reckitt and Rowntree were dominated by their owners and only had small professional management. The consequences were most seriously felt in those industries that required large-scale investments - chemicals, electrical equipment and metals; these declined markedly in relation to their German and US competitors. As a consequence, as Ross McKibbin has noted, between 1920 and 1939, around 1/5th of English millionaires (‘landed’ and ‘non-landed’) were in food, drink and tobacco and, in the post Second World War period, family fortunes were made in the service sectors, most notably by Moores, Sainsbury and Wolfson.[16] Problems of family disputes have featured prominently in UK newspapers over the last few years. The stereotypical image of the British family firm is that it was founded by fanatical fathers and succeeded by squabbling siblings who “worked at play and played at work”.[17] Family disputes are also illustrated by a prominent German firm: when Friedrich Krupp unexpectedly married a 21-year old girl at the age of 67, his in-laws demanded back the considerable sums that had they had lent him and completely ruined him.

Why then, given its evident deficiency, is private, in particular family, control so pervasive throughout the world? The thesis that I will develop is that while private as

[15] Chandler, A.D. (1990), *Scale and Scope: The Dynamics of Industrial Capitalism*, Cambridge: Harvard University Press.
[16] McKibbin, R. (1998), *Classes and Cultures: England, 1918-1951*, Oxford: Oxford University Press, p. 40.
[17] Landes, D. (1965), “Technological change and development in Wesern Europe 1750-1914”, in H.J. Habakkuk and M. Postan (eds), *Cambridge Economic History of Europe, Vol VI: The Industrial Revolution and After*, Cambridge: CUP, pp 536-64.

against public control has its deficiencies, market incompleteness makes private control a necessity for certain types of economic activity.

Let me illustrate this by contrasting entrepreneurship in 20th century California with that in 19th century Germany. Venture capital in Silicon Valley is provided by two groups of participants: general and limited partners. General partners have unlimited liability and are actively engaged in the screening and monitoring of prospective entrepreneurs. They are often entrepreneurs themselves who have successfully created their own companies and have moved into the management of portfolios of firms. Limited partners are the providers of capital, financial institutions and individuals, who are protected by limited liability.

The entrepreneurs and the general managers are on high reward, fixed term contracts. Finance is staged and curtailed if performance is poor, and partnerships are wound up after ten years. During the 1980's venture capital funds earned returns of around 25% per annum and general partners received 20% of the gains of the partnership in addition to stated fees. Exit is frequently by stock market flotation often after a period of five to ten years.

In contrast, in the first half of the 19th century Germany financial markets were non-existent and banks were poorly developed. Finance was generally provided by the family, frequently through inheritance and marriage and usually in the form of fixed interest credits or deposits with a share of the profits. It was granted without involvement in the management of the firm. The dowries that went along with Mayer Amschel and Nathan Rothschild's marriages were crucial to the financing of the early Rothschild activities.

A common feature of the two forms of entrepreneurship is the separation of claims over earnings streams from control over operations. Both the general/ limited partnership in the US and the German family organizations are similar to the medieval corporation, the *commenda*, sometimes referred to as the "sleeping partnership". This involved lenders bearing the risks of capital and being entitled to the share of the profits, and managing borrowers bearing the risks of labour and keeping the rest of the profits. However, there is an obvious distinction between the two. In contrast to the five to ten year exit period of a US venture capital fund, German firms remained under private ownership for extended periods of time.[18] Typically, if a German firm went to the stock market it only did so

[18] When Alfred Krupp, the founder of Krupp, drew up his will, his son Friederich had no male heirs. The firm was therefore converted into a joint stock company but the family retained nearly all of the shares and continued to exercise decisive control through chairmanship of the supervisory board. Brockstedt, J.

after approximately fifty years and many of the most successful firms never did – they remained private. Furthermore, once they had been floated, the original owners retained control. If they sold out they did so through private trade sales of blocks of shares; changes of control through market purchases on the stock market were virtually unknown. The dominant family interests observed in Continental Europe today were therefore either established at origin or acquired through subsequent block purchases.

In contrast, after the initial flotation on the stock market, a majority of shares of UK or US corporations become widely held on the stock market after a short period of time – in the UK typically after six years. Figure 10 contrasts the development of Anglo-American and Continental European firms from being small privately run enterprises to being large publicly listed corporations. In private enterprises in all countries control is concentrated in the hands of a small number of owners. On the Continent, ownership of earnings is dispersed but control remains concentrated in the hands of a small number of investors. Once UK and US firms are listed on their markets, control is rapidly dispersed and they are subject to changes in control through market purchases and tender offers on the stock market as well as voluntary trades by the original owners. The UK and US market systems therefore provide strong incentives for investment in entrepreneurial companies through creating liquid markets in stocks. The Continental European system provides incentives through the creation of private control rights.

Perfectly functioning markets in corporate control allow control to be purchased by those who attach the highest value to acquiring it and ensure that at any point in time the value of exercising control is maximized. In German firms, control rents remain with the original entrepreneurs and are transferred through subsequent generations of owners. There is no market in corporate control and no assurance that the value of control is maximized. However, private control rights are preserved and incentives to maintain and enhance their value are retained.

Markets are more efficient control mechanisms where private control incentives are not required. However, there is much evidence to suggest that the costs of control and therefore required financial returns are high. Firstly, we have just observed that the managers (general partners) of venture capital firms require at least 20% of the total returns on portfolios that earn on the order of 25% per annum over a ten-year period. While risks of venture capital investments are large, most of these are specific to the

(1984), "Family enterprise and the rise of large-scale enterprise in Germany, 1871-1914", in A. Okochi and S. Yasuoka (eds), *Family Business in the Era of Industrial Growth: Its Ownership and Management*, University of Tokyo Publishing.

particular investments and can therefore be eliminated through portfolio diversification. Risk does not justify these high rewards but active governance almost certainly does.

Secondly, premia in takeovers in the UK and US are of the order of 30%, as against just 10% in Germany.[19] Gains to shareholders from competitive markets in control are therefore considerable. Thirdly, discounts on closed-end mutual funds in relation to the value of the underlying securities are in excess of 10%. The private benefits of control of mutual funds are large and only eliminated when control is transferred to investors on conversion to open-end status. In the presence of such large costs of control, markets only function where substantial financial returns are expected. The elimination of private benefits of control in the UK and US therefore comes at the expense of incentives to invest.

It is not therefore surprising to discover that the most important periods of stock market expansion have coincided with major technological innovations when returns to investment were exceptionally high. In the UK, these were associated with financing of the canals at the end of the 18th century and investment in railways in the 19th century. They are now associated with the information technology revolution. But stock markets are less well suited to financing activities that offer more modest returns, most notably investment in manufacturing. The third assertion therefore is that different types of corporate systems are associated with different types of activities:

Assertion 3: Different forms of corporate control are associated with different types of economic activities

Private benefits are required in the initial stages of development of corporations and economies before high financial returns are anticipated. Markets are rarely associated with corporate control in small companies or countries in their initial stages of development. In both cases, the value of private benefits comes from their ability to encourage investments that would otherwise be subject to capital market failures. Some of the most beneficial are non-pecuniary in nature and many come from networks of associations. Mayer Amschel Rothschild's association with Prince William IX of Hesse-Kassel was crucial in his early commercial activities and this relation was greatly assisted by their common interest in coin collection. In the case of family firms at the end of the 19th century in Britain and many developing countries in the 20th century there has been a

[19] See J. Franks and C. Mayer (1998), "Ownership and control of German corporations", mimeo.

failure to exploit this potential advantage of private benefits. I will assert shortly that this results from deficiencies in the relation between financial and corporate systems.

Assertion 4: Institutional design determines patterns of private and public cash flow and control rights that affect the balance between eliminating constraints on investment and achieving ex post efficiency in allocation of control.

In part, private control incentives obviously reflect social and cultural considerations. An entrepreneurial spirit is clearly encouraged by having traces of the Gold Rush in ones blood. But the trade-off between private and public control rights is also a function of structural characteristics of an economy. What we were looking at earlier on was the equivalent of the molecular structures of companies. Like their chemical equivalents they determine the properties and behaviour of firms.

Modern finance theory emphasizes the benefits of portfolio diversification. As I mentioned in the context of venture capital firms, by holding several shares in a portfolio, investment risk can be reduced. Some of the risks simply cancel out in the sense that when one company is doing well another is doing badly. From the perspective of financial returns, there is no benefit to concentrated shareholdings. However, from a control perspective, there are considerable potential gains. The reason is that the returns to corporate control may be substantially magnified. Let me give an example.

If Giovanni Agnelli or Albert Frére fail to discipline slack management in one of their companies then they can anticipate lower returns elsewhere. The effects of poor corporate governance in one part of their empires reverberate throughout. Even if the direct financial repercussions of failure in the firm in question are small, the overall effects may be substantial and incentives to active corporate governance are enhanced. Private benefits therefore provide a commitment mechanism. But commitment restricts flexibility and correlations in control are impediments where individual initiative and innovation should be encouraged. Concentrations of control can therefore be used to enhance private benefits where market incentives are inadequate and commitments are required; dispersed ownership can be used to exploit the benefits of flexibility in market control.

Not only does this trade-off depend on types of economic activity and stages of development but it also changes over time. I have mentioned the fact that markets in corporate control function well where private benefits are not required to encourage investment. We are currently going through a technological revolution that has shifted the balance of advantage between private encouragement to investment to markets in control. The comparative performance of different systems around the world is therefore not surprising; it may persist for some time, but as in the 19th century, it is unlikely to continue indefinitely.

It should be noted in passing that the importance of private benefits is quite distinct from notions of stakeholder interests. According to the stakeholder view, several different parties contribute to the activities of the firms – employees, suppliers, purchasers and communities – as well as shareholders. Many of them are required to make investments that are sunk in the sense that if the firm changes its activities or closes down, they will be unable to recover them. For this reason, it is argued that stakeholders should have some controlling interest in firms, for example blocking minorities, which allow them to protect their sunk investments.

It is doubtful whether this harmonious co-existence of several different interested parties is a feature of any economies. Even in Germany, where co-determination and worker councils are thought to exemplify a stakeholder economy, it is questionable whether workers exert effective control over substantive decisions. Instead, private benefits provide a form of co-insurance that allows managers or owners to make greater commitments to investors and other stakeholders. They diminish risk of default in respect of investors and stakeholders by placing private as well as public capital at stake.

5 Corporate finance

A theory of private benefits has clear implications for corporate finance:

- Private benefits will have to be largely self-financed,
- Control rights will be central to the provision of external finance.

These explain many of the stylized features of corporate finance to which I referred at the beginning:

- Most investment will have to be self-funded out of retained earnings,
- The comparatively large amount of equity finance in Continental European countries has nothing to do with stock markets. It is equity primarily provided by families and other companies,

- Where market equity finance is provided in the UK and US, it is mainly associated with changes in control around initial public offerings, takeovers, management buy-outs etc.,
- Institutions rather than markets provide most external finance.

Assertion 5: Patterns of corporate finance reflect magnitudes of private benefits.

Existing theories of finance emphasize information deficiencies of financial markets. They point to the information advantages of using retained earnings in preference to external finance and low risk debt finance in preference to external equity. But the main distinction that arises in practice, as I noted at the start, is not between debt and equity external finance but between the large proportion provided by banks in comparison to bond as well as equity markets.

A striking feature of bank finance is the high degree of collateralization of loans; throughout the world, banks require security to be provided against loans. The role of banks in the event of the failure of a borrower is to recover as high a proportion of a loan as possible. As I just described of private control of several activities, failure of a bank to take prompt action against one failing loan will lead to an expectation on the part of all of its borrowers that they can get away with loan losses. A bank therefore has stronger incentives to impose tight budget constraints than markets. They overcome a "free rider" problem of corporate control. The greater incentive for banks to exercise control in the event of failure allows private benefits of control to be preserved in the absence of failure.

Given their central importance, why do some countries apparently have more significant banking systems than others? This comes to the final thesis of this lecture.

6 Regulation and the evolution of systems

I have argued that institutional design affects the balance between private and public benefits in a society and that this should be tailored towards achieving an appropriate trade-off between overcoming investment constraints and efficiency in allocation of control. But not surprisingly, private benefits raise important public policy issues, namely fairness and power.

Assertion 6: The balance between private and public benefits has been affected by distributional as well as efficiency considerations. As a consequence, evolution of systems reflects political and regulatory interventions.

England, of course, led the way in terms of the development of the stock corporation. It emerged out of the guilds, as a way of funding overseas trading opportunities, the first being the Russia company under the governorship of Sebastian Cabot in 1553. The stock corporation expanded rapidly until the end of the 17th century. But in 1720, there was a major disaster. Between June and September 1720, the price of the South Sea Trading Company's shares declined from £1,050 per share to £190 per share. This resulted in the passing of the Bubble Act in 1720 which led, with some exceptions (most notably the canal companies), to the suppression of the stock corporation for more than a century until its repeal in 1825. To quote from one of the authorities on stock corporation: "It was pertinently said of this statute that like all laws passed upon the exigency of an occasion it had more of temporary malice and revenge than of permanent wisdom and policy".[20]

Protection of investors has featured prominently in English corporate and financial regulation. One of the major influences on the development of the banking system during the 19th century was a concern about bank failures. Local banks were important in the funding of manufacturing in the first half of the 19th century. Many bankers were originally engaged in a business for which banking was a sideline and a way of funding their main activities. They had interests in promoting the development of local industries in the same way in which the regional banking system in virtually every developed country other than Britain does today. But the existence of 800 small, private banks caused serious stability problems: between 1809 and 1831 there were 311 bank failures. The Bank Charter Act of 1844, which confirmed the supremacy of the Bank of England, did not eliminate banking crises but had a profound effect on the structure of English banking and the relation between banks and industry.

Protection of small investors continues to dominate UK regulation to this day. It is reflected in City rules on takeovers, Stock Exchange discouragement to dual class shares, Company Law treatment of minority investors, Bank of England dislike of excessive bank risk taking. All of this has admirable features about it. Small investors are protected, returns to corporate investment are widely distributed and the stability of the banking system is promoted. But it is not without costs for the pursuit of private benefits. I mentioned the fact that family interests dominated corporate activity in the UK at the turn of the century. In many respects these mirrored those of German corporations. But the

[20] Hunt, B.C. (1936), *The Development of the Business Corporation in England, 1800-1867,* Cambridge, Mass.: Harvard University Press.

main justification for the creation of private benefits was missing. Large-scale investment was absent, one explanation being the demise by then of a local banking network. It is not therefore surprising that by the middle of this century, concentrated family control had begun to be superseded by dispersed institutional control. However, the underlying problem of providing incentives and a means of financing large-scale investment remain unchanged.

In the US, no institution has exemplified the pursuit of private benefits and corporate power better than J.P. Morgan. In the 1880's, Pierpont Morgan co-ordinated rate support schemes in the railroads; in the 1890's, he took over control of a sixth of the country's railway trackage when it fell into receivership; in the 1900's, he organized the formation of U.S. Steel, a trust that would control more than half of US steel business, followed by International Harvester, which had an 85% share of the farm equipment market; and in 1907, in the absence of a central bank, he co-ordinated the provision of emergency bank finance to rescue fifty brokerage firms which faced collapse in the wake of a stock market crash. In 1912, the five largest banks in the US controlled assets representing 56% of the country's GNP. It is not surprising then that J.P. Morgan was at the centre of the anti-trust movement that swept the US at the turn of the century and in 1914, it announced that its partners would resign from the boards of 30 companies. But it did not stop J.P. Morgan launching into the formation of holding companies, such as the Alleghany Corporation, United Corporation and Standard Brands, at the end of the 1920's. Instead, it was financial rather than anti-trust regulation that finally acted as a break on its commercial power. In the aftermath of the stock market crash in 1929, Congressional hearings revealed that, in the process of creating these holding companies, J.P. Morgan had placed shares with a web of politically and commercially powerful allies. The consequence was an Act sponsored by Senator Carter Glass and Representative Henry Steagall which has separated commercial and investment banking in the US to this day.

Regulation has therefore acted as a brake on the pursuit of private benefits in the US as well as the UK. It is doubtful, however, whether it has gone as far as it has in the UK. One of the checks on regulation in the US has been the fact that corporate law is organized at the state rather than the federal level. States compete with each other in the lucrative business of incorporation. They have to be mindful of the interests of management in wishing to protect themselves against threats of takeovers as well as those of shareholders seeking to incorporate in states that will maximize shareholder value. The result has been that legislation in many states provides for more protection to incumbent management through anti-takeover devices such as poison pills than corporate law in the UK.

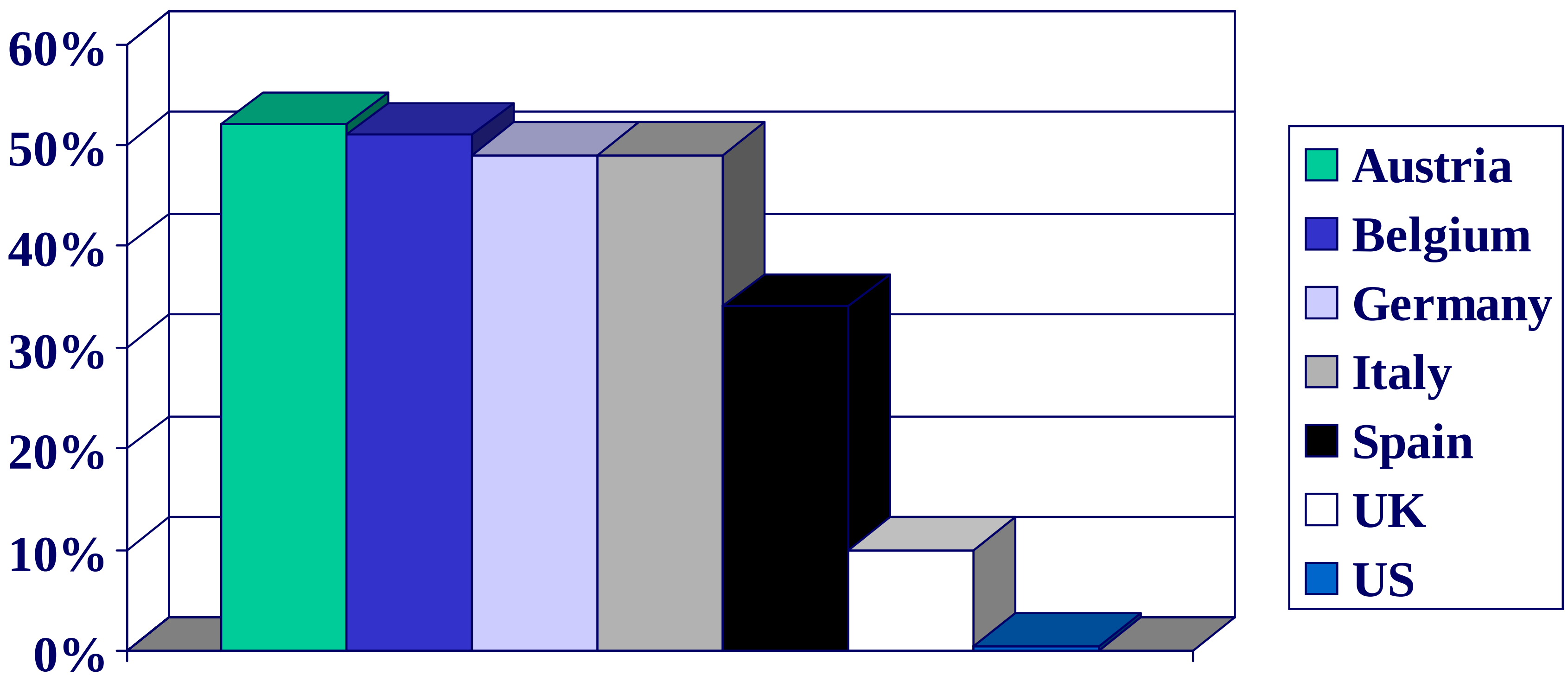
The UK therefore goes further than virtually any other system in restricting private benefits. The advantage is that we live in a society in which there is less concentration of power, more protection of minorities and small investors, and less risk of banking failure. The drawback is that there is less incentive to invest in activities that markets are inadequate to sustain. It is a trade-off with which we may feel comfortable. But we should perhaps also be aware that while absolute power may corrupt, absolutely no power may eventually bankrupt. The conflict was of course better expressed by Rudyard Kipling talking about Lord Beaverbrook – "power without responsibility: the prerogative of the harlot throughout the ages" and by Tom Stoppard writing about the House of Lords – "responsibility without power, the prerogative of the eunuch throughout the ages". Whereas we have extensive theories to guide tax policy in trading off distribution and efficiency, and anti-trust policy in trading off monopoly distortions and incentives, we have few theories to guide regulatory policy in trading off private and public benefits of control.

7 Conclusion

To summarize, I have argued that there are pronounced differences across countries in the concentration of corporate power and the separation of ownership and control. I have suggested that those differences are associated with private benefits of control. I have noted the substantial abuses associated with private benefits but have also argued that they may be central to the promotion of investment. In particular, non-pecuniary benefits in the form of honour, prestige and family names provide cheap ways of overcoming capital market constraints. The dominance of family control in many countries may reflect the powerful incentives to invest that this form of corporate organization provides. I have suggested that the prevalence of private benefits is a reflection of structural characteristics of corporate sectors as well as cultural differences between countries and that different systems may be best suited to different types of activities. I have proposed that the striking features of corporate finance that have been recorded elsewhere can be explained in terms of the significance of private benefits. I have argued that the evolution of different systems in large part reflects a resolution of tensions between private and public interests through the political and regulatory process and that the public policy debate on this issue has not yet even begun. Finally, I have argued that the resolution in the UK has been too far in the direction of favouring public over private benefits – a British predilection for eunuchs over harlots.

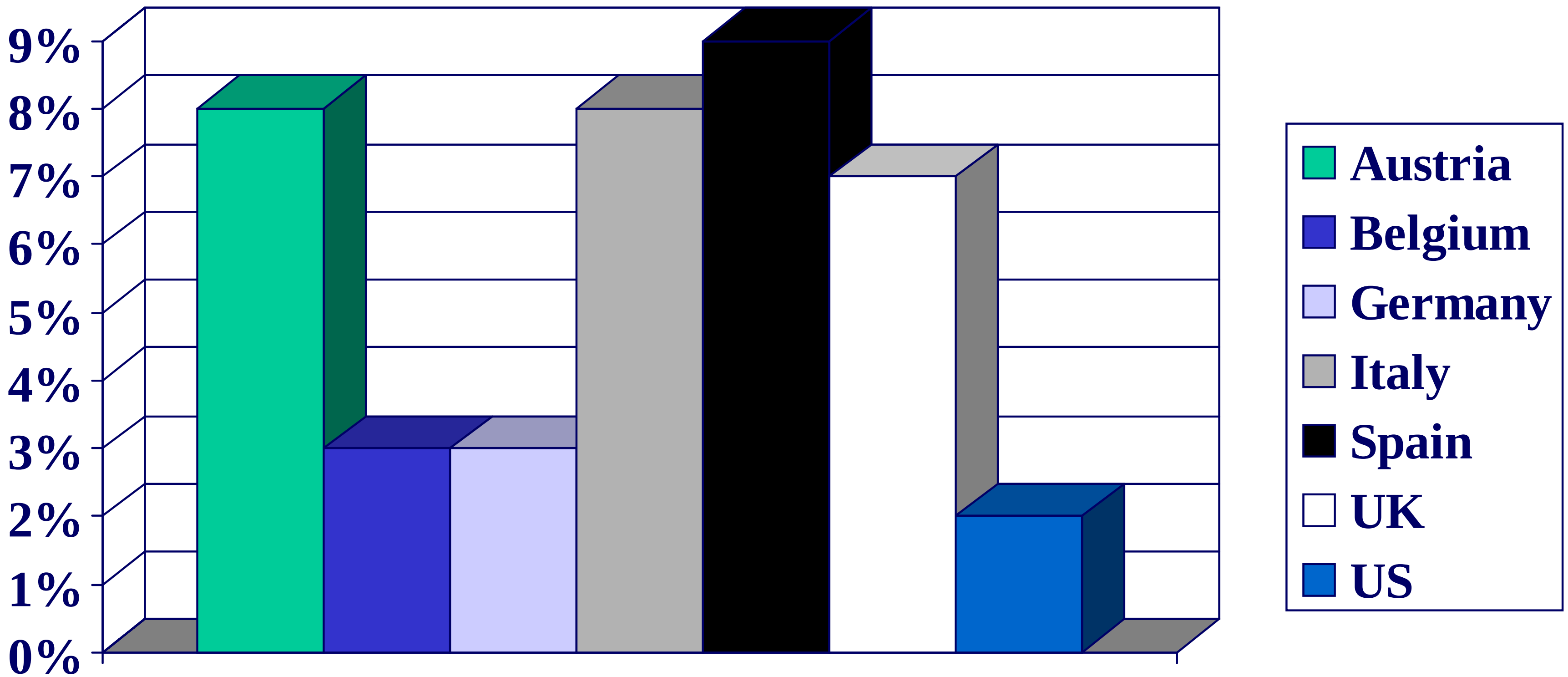
I hope that I have now provided some basis for understanding why, while we would wish the garages, restaurants and time keepers to be owned by the Germans, French and Swiss, we would want the police to be controlled by the British. But I have not explained why the lovers should be Italian. There again, I need to leave something for my next inaugural lecture; and after all, it has nothing do with firm control, has it?

Figure 1: Percentage of Votes Cast by Largest Voting Block (Median)



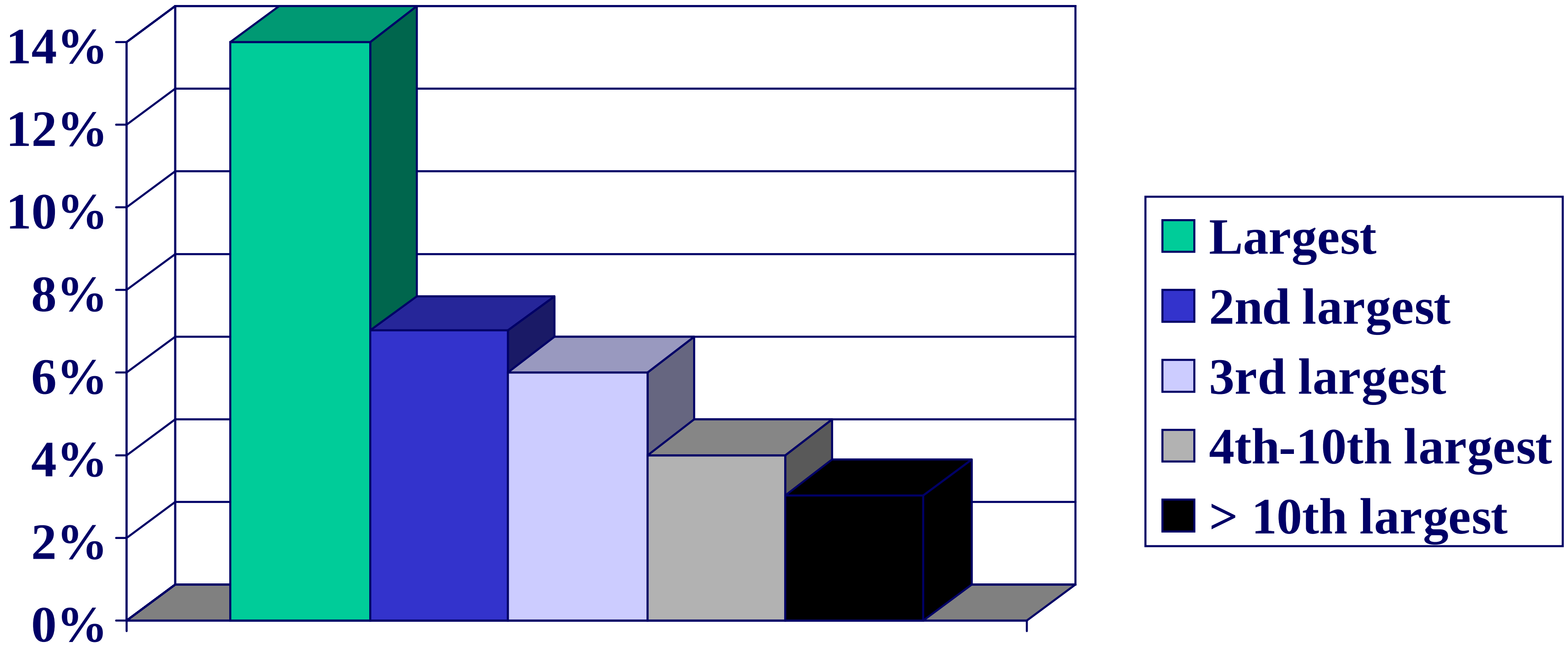
Source: ECGN Project, "Who Controls Corporate Europe?"

Figure 2: Percentage of Votes Cast by 2nd Largest Voting Block (Mean)



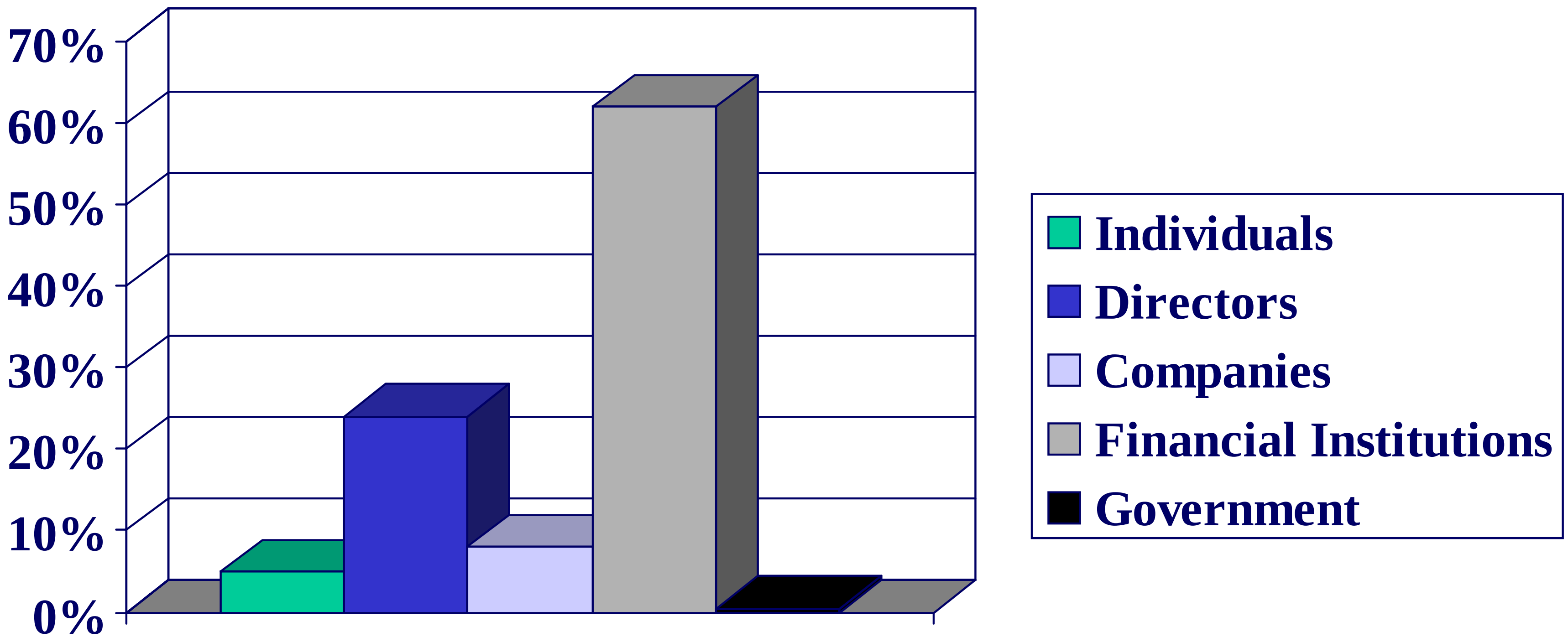
Source: ECGN Project: "Who Controls Corporate Europe?"

Figure 3: Size of Voting Blocks in the UK (Means)



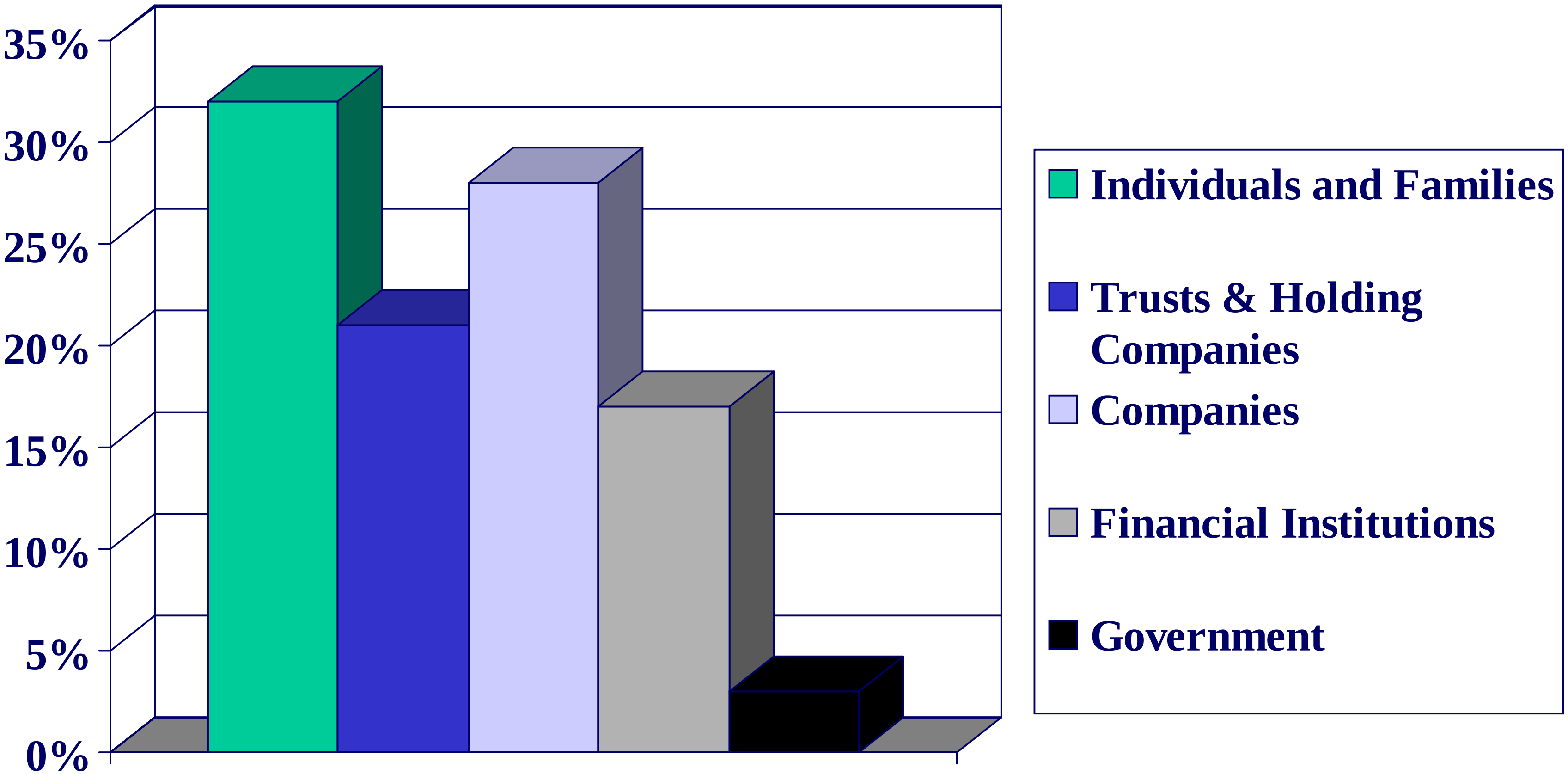
Source: M. Goergen and L. Renneboog: "Strong Managers and Passive Institutional Investors in the UK", ECGN Project

Figure 4: Percentage of Voting Blocks Associated with Different Types of Investors in the UK



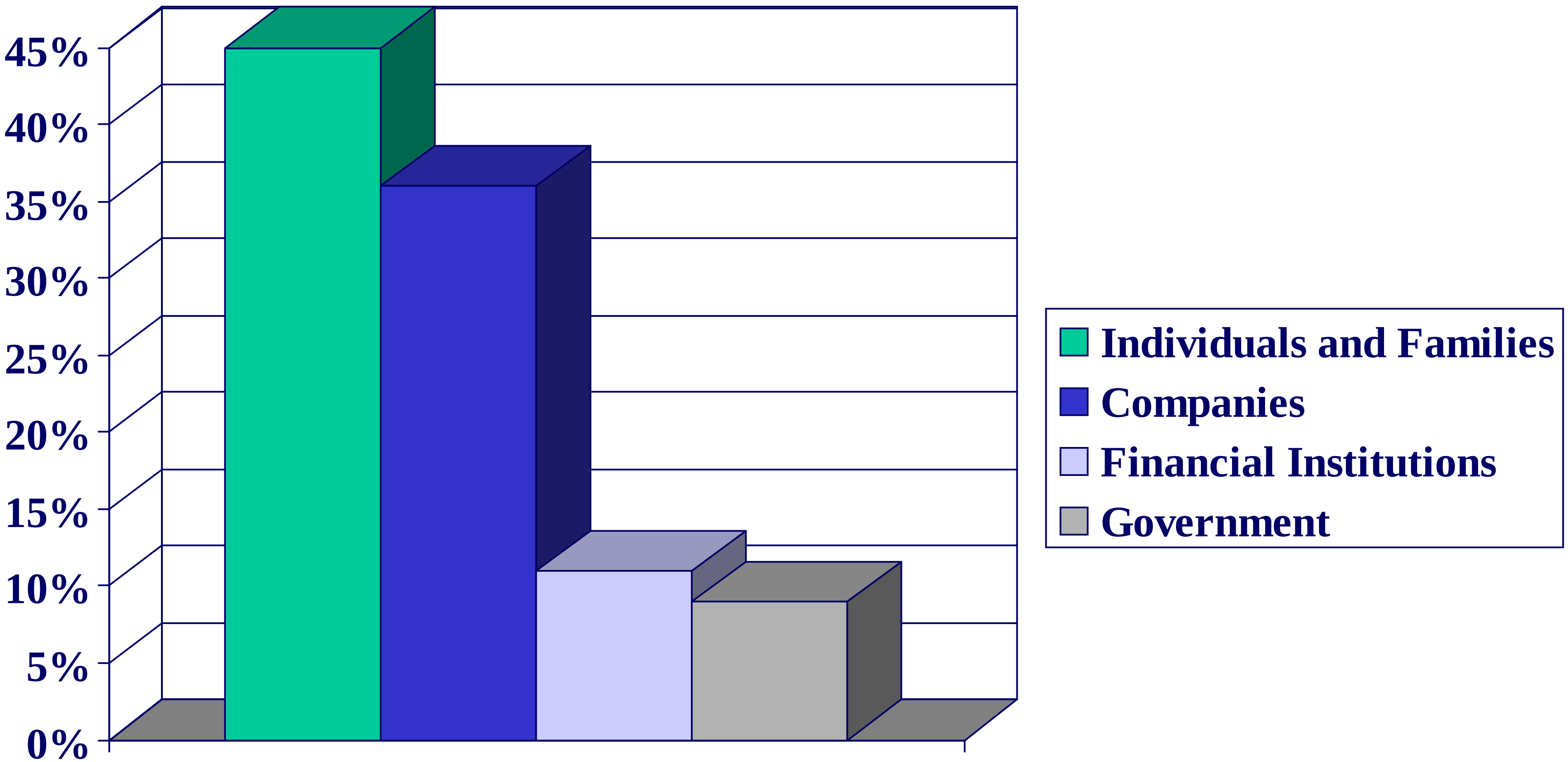
Source: M. Goergen and L. Renneboog, "Strong Managers and Passive Institutional Investors in the UK", ECGN Project

Figure 5: Percentage of Voting Blocks Associated with Different Types of Investors in Germany



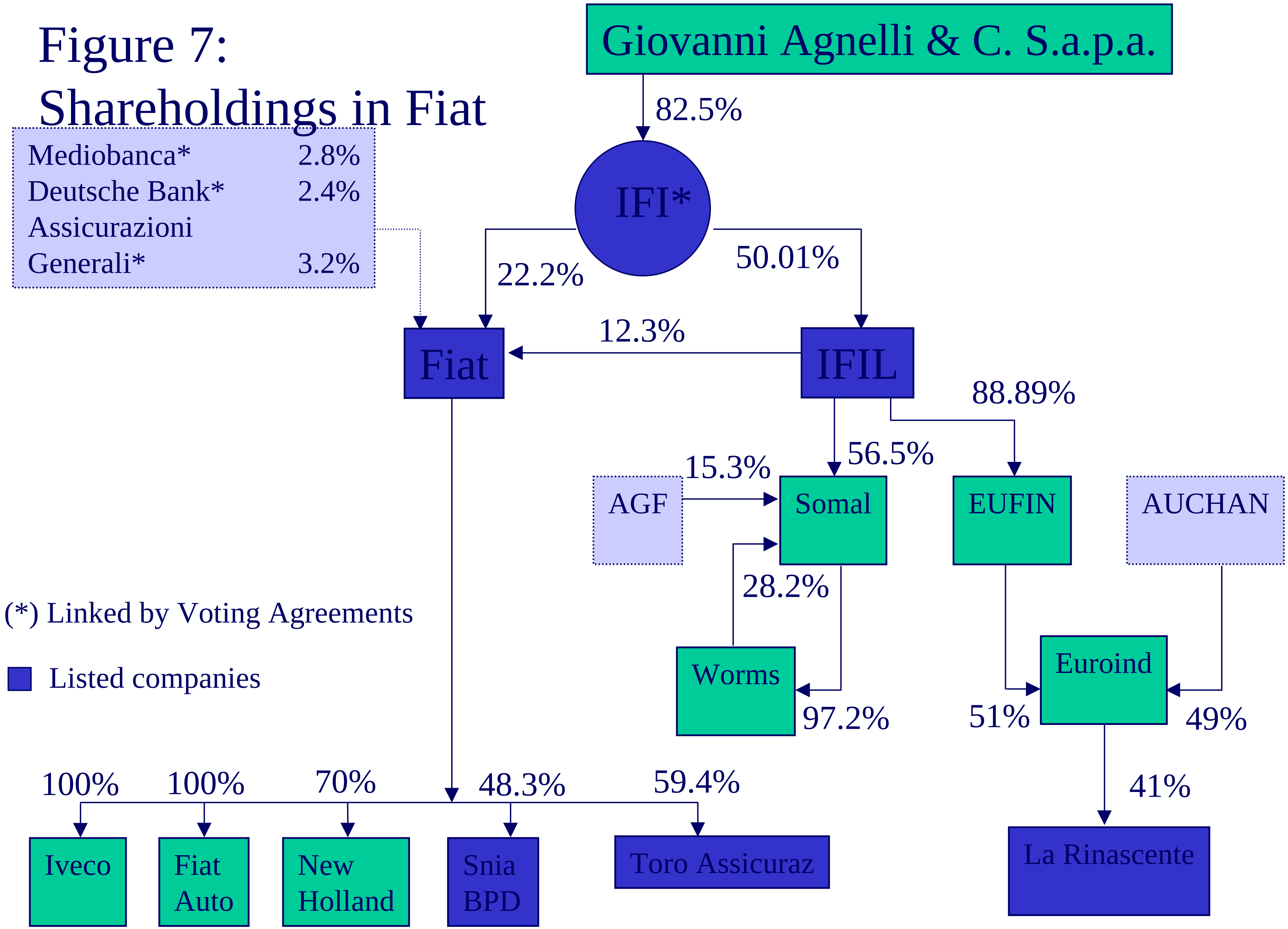
Source: M. Becht and E. Boehmer, "Transparency of Ownership and Control in Germany", ECGN Project

Figure 6: Percentage of Voting Blocks Associated with Different Types of Investors in Austria



Source: K. Gugler, S. Kalss, A. Stomper and J. Zechner, "The Separation of Ownership and Control: An Austrian Perspective", ECGN Project

Figure 7:
Shareholdings in Fiat



Source: M. Bianchi, M. Bianco and L. Enriques, “Pyramidal Groups and the Separation Between Ownership and Control in Italy”, ECGN Project

Figure 8: Shareholdings of Paul Desmarais and Albert Frére

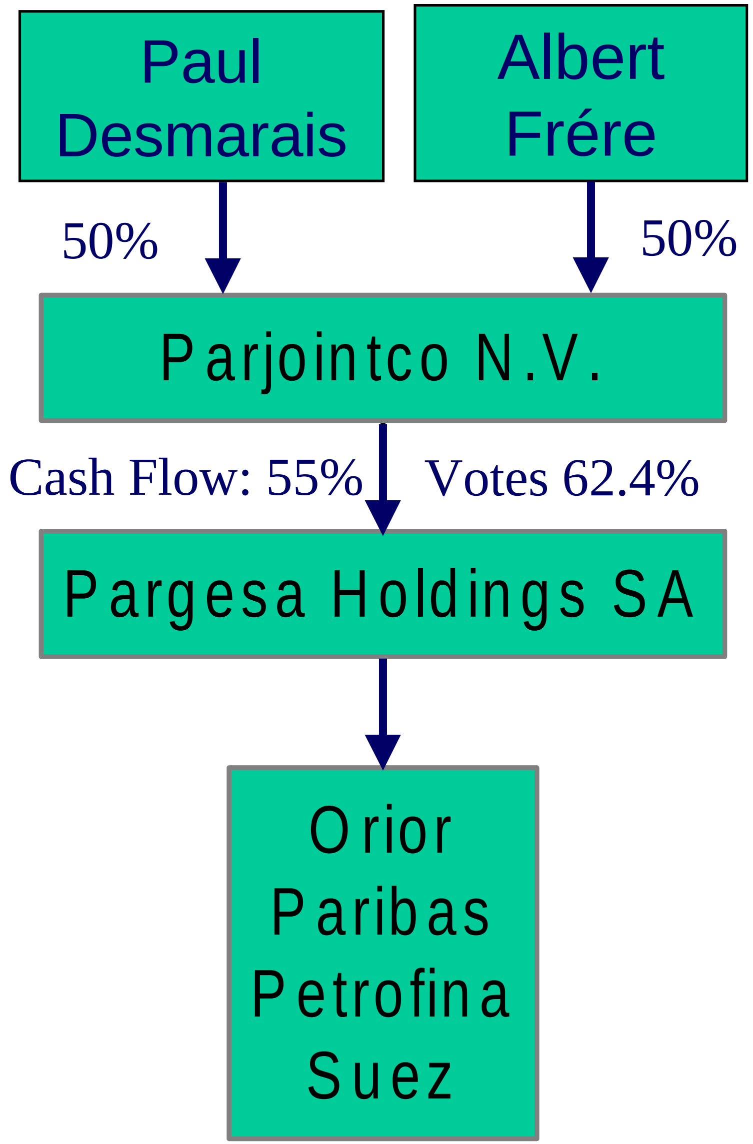


Figure 9: Paul Desmarais' Pyramid Holding

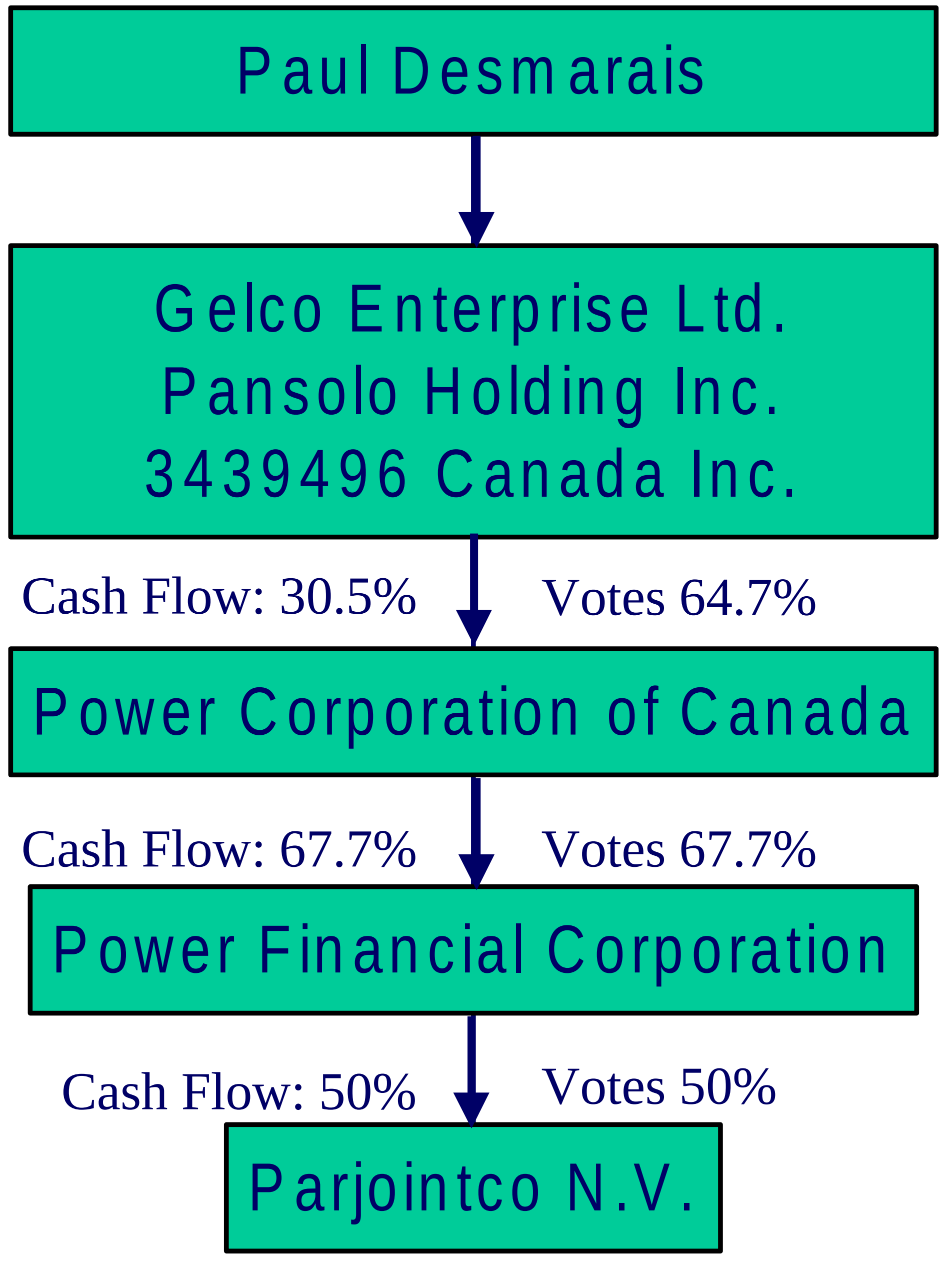


Figure 10: Evolution of Control