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The Global History of Corporate Governance
An Introduction

Randall K. Morck and Lloyd Steier

To Whom Dare We Entrust Corporate Governance?

Capitalism at the beginning of the twenty-first century is a variegated collection of economic systems. In America, *capitalism* is a system where a huge number of independent corporations compete with each other for customers. Monopolies are illegal, though the courts are sometimes an imperfect safeguard against them. Each corporation has a chief executive officer (CEO) who dictates corporate policies and strategies to a largely passive board of directors. The true owners of America's great corporations, millions of middle-class shareholders, each owning a few hundred or a few thousand shares, are disorganized and generally powerless. Only a handful of institutional investors accumulate large stakes—3 or even 5 percent of an occasional large firm's stock—that give them voices loud enough to carry into corporate boardrooms. Corporate CEOs use or abuse

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their considerable powers in accordance with their individual political, social, and economic beliefs. In much of the rest of the world, *capitalism* is a system where a handful of immensely wealthy families control almost all of a country's great corporations, and often its government to boot. Competition is largely a mirage, for few firms are genuinely independent. Professional managers are hired help, subservient to oligarchic family dynasties that jealously safeguard their power, sometimes at great cost to their host economies.

The purpose of this volume is to explore how capitalism came to mean, and to be, such different things in different parts of the world. How did some economies come to entrust the governance of their great corporations to a handful of old moneyed families, while others place their faith in professional CEOs?

Such different usages of the word *capitalism* make for difficult communication. American economists are often baffled by the reluctance of seemingly well-educated foreigners to embrace the tenets of free enterprise, and foreign economists marvel at the naive simplicity of their American colleagues. In fact, each would do well to take the other more seriously. The rest of the world is not simply like America, but usually poorer to varying degrees. Different countries' economies are organized in very different ways, and corporate governance—that is, decisions about how capital is allocated, both across and within firms—is entrusted to very different sorts of people and constrained by very different institutions.

A key study that forces this point upon the economics profession is by La Porta et al. (1999), who contrast the ownership of large and medium-sized companies across countries. Figure 1 illustrates their findings.[1] The central message of figure 1 is how very different different countries are. The large corporate sector of Mexico is entirely controlled by a few enormously wealthy families, whereas all the largest British companies get by with no controlling shareholders at all. Most Argentine firms are controlled by wealthy families, but most great American corporations are not. Wealthy family domination of great corporations is not restricted to poor countries but also characterizes relatively rich economies like Israel, Hong Kong, and Sweden.

Nonetheless, Claessens, Djankov, and Lang (2000), Khanna and Rivkin (2001), and many others document the ubiquity of family-controlled

1. La Porta et al. (1999) list several large German and Japanese firms as having no controlling shareholder. However, because German banks typically vote the shares of small investors, Baums (1995) shows that these firms are actually controlled by banks. All the large Japanese firms La Porta et al. list as having no controlling shareholder are members of corporate groups called *keiretsu,* in which each firm is controlled collectively by other firms in the group. Although each group firm's stake in every other group firm can be small, these stakes accumulate to control blocks. Figure 1 is based on La Porta et al. for all other countries. We are grateful to Raphael La Porta for making the names of the top firms in each country available to us.

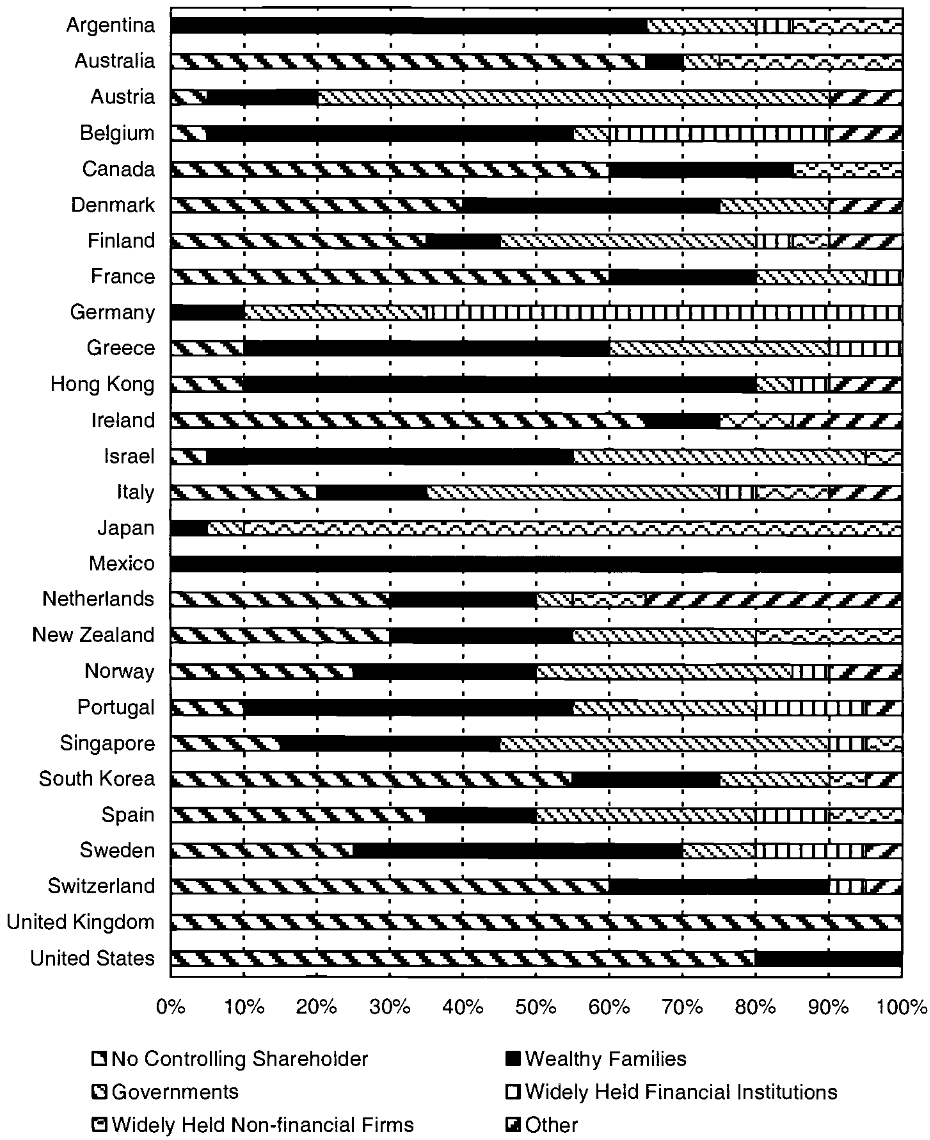

Fig. 1 Who controls the world's great corporations?

Sources: La Porta et al. (1999) with Japanese data augmented by Morck and Nakamura (1999) to account for combined *keiretsu* stakes and German data augmented with information from Baums (1995) to account for bank proxy voting.

Notes: Fraction of top ten firms with different types of controlling shareholders is shown for each country. Control is assumed if any shareholder or group of shareholders believed to work in consort controls 20 percent of the votes in a company's annual shareholder meeting.

corporate groups in poor countries. In general, poor economies have corporate sectors controlled by some mixture of state organs and wealthy families. The variety illustrated in figure 1 is primarily a feature of the developed world.

The fact that most large U.K. and U.S. firms are widely held, while most large firms elsewhere are controlled by a few wealthy families, is perhaps insufficient to explain the different perceptions of capitalism that hold force in different countries, for independent firms that compete with each other still lead to economic efficiency regardless of who controls them. However, a second feature of corporate governance in most countries, the *pyramidal business group* or *pyramid* for short, magnifies the economic importance of this difference enough to create genuinely different economic systems, all of which go by the name of capitalism.

A pyramid is a structure in which an apex shareholder, usually a very wealthy family, controls a single company, which may or may not be listed. This company then holds control blocks in other listed companies. Each of these holds control blocks in yet more listed companies, and each of these controls yet more listed companies. Structures such as these are ubiquitous outside the United Kingdom and United States. They can contain dozens or hundreds of firms, listed and private, and put vast sweeps of a nation's economy under the control of a single family. These are the structures that permit tiny elites to control the greater parts of the corporate sectors of many countries.

Berle and Means (1932), Bebchuk, Kraakman, and Triantis (2000), Morck, Stangeland, and Yeung (2000), Claessens, Djankov, and Lang (2000), and many others demonstrate the severe corporate governance problems that can occur in pyramidal business groups. However, these problems are only of interest in this volume to the extent that they motivate the formation of business groups, or their dissolution. Our focus is on how the differences in corporate control illustrated in figure 1 came to be.

The remainder of this chapter is laid out as follows: section 2 explains why the differences outlined in figure 1 matter. Indeed, they are the key distinguishing features that define different forms of capitalism. Section 3 then briefly describes the key arguments and findings of each chapter. Section 4 then sorts through these findings, highlighting common threads that connect to current thinking about corporate governance. Section 4 goes on to consider the implications of these threads, and section 5 provides a summary.

Does It Matter?

Capitalism is thus called because it is an economic system organized around the production and allocation of capital. The savings of individuals are the basis of all capital. Yet the ways in which economies accumulate and allocate capital are quite different in different countries, and seem closely related to how each country handles corporate governance issues.

Individuals can save by investing in corporate stocks and bonds. Companies they view as good bets can raise huge amounts of money by issuing securities—as when Google raised $1.67 billion by selling new shares to the public in 2004.[2] A company that investors feel is a poor bet has difficulty raising any substantial amount by issuing securities. For instance, the Internet-based sales intermediary deja.com withdrew from its proposed share issue in 2000, after it became clear that investors were not likely to pay the sort of price management hoped for.[3]

If investors know what they are doing, capital is allocated to firms that can use it well and is kept away from firms that are likely to waste it. This process underlies *shareholder capitalism,* as practiced in the United Kingdom and United States. Firms in those countries that can issue stock and bonds to investors acquire funds to build factories, buy machinery, and develop technologies.

For investors to trust a company enough to buy its securities, they need reassurance that the company will be run both honestly and cleverly. This is where corporate governance is critical. The corporate governance of large corporations in these countries is entrusted to CEOs and other professional managers. Investors collectively monitor the quality of governance of each listed firm, and its share price reflects their consensus.

This system has costs. Monitoring the quality of corporate governance in every firm in the economy eats up resources. American and British capital markets and regulators try to shift this cost away from investors by mandating that firms disclose detailed financial reports, insider share holdings, management pay, and any conflicts of interest. Other rules proscribe stock manipulation, certain trading, and other self-dealing by corporate insiders. Shareholders can sue the directors and officers of any company that violates these rules. These prohibitions aim to help investors by adding regulatory and judicial oversight to the mix. And raiders and institutional investors stand ready to toss out managers who seem either inept or dishonest. These deep-pocketed investors can afford to bear a disproportionate share of the cost of monitoring corporate governance and of cleaning up governance problems when they arise.

This system is certainly imperfect. Good managers are penalized and poor ones rewarded if investors get things wrong, and this seems to happen with some regularity, as during the dot.com boom of 1999 when investors bought Internet-related company shares with apparently irrational enthusiasm. But over the longer term, through the ebbs and rises of the busi-

2. See "Google's Stock Offering Didn't Follow Script," *Billings Gazette,* 20 August 2004.
3. See "After failed IPO, Deja.Com Attempts to Reanimate," by Jason Chervokas, atNewYork.com, 4 February 2000.

ness cycle, Anglo-American capitalism seems to deliver high standards of living.

But Anglo-American shareholder capitalism is exceptional. Other systems predominate, and La Porta et al. (1999) find that the most common system of corporate governance in the world is *family capitalism,* in which the governance of a country's large corporations is entrusted to its wealthiest few families. This situation might arise if investors are deeply mistrustful of most companies and prefer to invest by entrusting their savings to persons of good reputation. Family firms constitute larger fractions of the stock markets of countries that provide investors with fewer legal rights. Respected business families can leverage their reputations by controlling many listed companies, and by having listed companies they hold control blocks of other listed companies, in successive tiers of intercorporate ownership. Such pyramidal business groups are also more common where investors' legal rights are weaker.

Yet family capitalism also has its problems. Corporate governance in many countries is remarkably concentrated in the hands of a few wealthy families. Governance can deteriorate over a wide swathe of the economy if the patriarch, or heir, controlling a large business group grows inept, excessively conservative, or overly protective of the status quo. Since the status quo clearly has advantages to these families, the last possibility is especially disquieting. For example, they might lobby to keep shareholder rights weak so that upstarts cannot compete for public investors' savings.

Another way investors can save is by putting money in a bank or other financial institution. The bank then lends the money to companies to buy factories, machinery, and technologies. Or sometimes the bank actually invests in other companies by buying their shares or bonds. This constitutes another way in which economies can accumulate and allocate capital. Banks play much greater capital allocation roles in German and Japanese capitalism than in the Anglo-American variant, although, as Morck and Nakamura (1999) and Fohlin (chap. 4 in this volume) show, their role may have been somewhat overstated in both countries.

In *bank capitalism,* oversight by bankers substitutes for shareholder diligence. Bankers monitor the governance of other firms and intervene to correct governance mistakes. If errant managers refuse to change their ways, banks withhold credit, starving the misgoverned firm of capital. As long as the bankers are altruistic and competent, this system can allocate capital efficiently. However, if a few key banks are themselves misgoverned, the ramifications are much worse and can create problems across all the firms that depend on that bank for capital. Bank capitalism delivered solid growth in postwar Germany and Japan, and in emerging economies like Korea. But in all three, overenthusiastic lending by a few top bankers to misgoverned firms created financial problems that continue to hinder macroeconomic growth.

Yet another way investors can save is by paying taxes and letting the state provide capital to businesses. In its extreme form, this is the guiding principle of socialism. But industrial policies—state-guided capital accumulation and allocation—are important in many free-market economies as well, especially historically. For example, the Fascist governments of Germany, Italy, and Japan all imposed this form of corporate governance upon virtually all their large corporations. More democratically formulated industrial policies played large roles in the economies of Canada, Japan, India, and all major continental European economies, as well as in many emerging-market economies. Nationalized industries in mid-twentieth-century Britain and massive defense and public works investments in the United States also count as industrial policies.

In *state capitalism,* public officials supervise corporate managers and intervene to correct any governance problems. If the bureaucratic overseers are able and altruistic, they can direct corporate decision making down paths that promote the general good. But intractable governance problems arise if the public officials have inadequate ability or knowledge to make such decisions or if they skew decisions to benefit politically favored persons or groups. State capitalism delivered brief periods of high growth in many countries, but it seems prone to serious governance problems of these sorts over the longer run.

Finally, investors can save by hoarding gold and silver coins. If people mistrust financial markets, wealthy families, bankers, and politicians, this may be the only option left. Murphy (chap. 3 in this volume) argues that a series of financial scandals and crises in France actually did reduce generations of Frenchmen to burying coins in their yards to provide for their futures, and that this mistrust retarded French financial development severely. When the savings of the broader public are unavailable to business, each company must grow using its earnings alone. This automatically allocates additional capital to those who already control companies, which is unlikely to be economically efficient. It also makes getting started very difficult for impecunious entrepreneurs.

Of course, no country is a pure example of any of these flavors of capitalism. Each variant of capitalism accounts for part of the capital formation in all the countries covered in this book. But the different variants clearly have different relative importance—both across countries and over time—and these differences are of great moment. Entrusting corporate governance to wealthy families, a few powerful bankers, or a cadre of bureaucrats might seem profoundly undemocratic to some. Entrusting it to anyone but civil servants, chosen by elected officials, might seem undemocratic to others. And entrusting corporate governance to anyone but reputable leading families might seem rashly irresponsible to still others. Moreover, as the chapters of this book show, impersonal stock markets, banks, wealthy families, and government bureaucrats each arise from different circumstances, operate in different ways, and bring different sets of issues to the fore.

Why Did Different Countries Follow Different Paths?

This volume contains one chapter describing the history of corporate governance in each member country in the Group of Seven (G7) of leading industrialized nations: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. To these we add a chapter on the Netherlands, because it is the oldest capitalist economy, and many of the institutions that determine corporate control elsewhere originated there. We also add a chapter on Sweden because it is the standard bearer of an alternative *Swedish model* of capitalism tempered by social democracy. Finally, we add a chapter each on India and China—the world's two largest developing economies. This list is incomplete—omitting such important countries as Australia, Russia, Spain, and Switzerland, not to mention much of Asia and all of Latin America, Africa, and the Middle East. It is our hope that other students of corporate finance or economic history will fill in these gaps.

Early stages of the research that led to this volume showed that the first large corporations almost everywhere were family businesses, and that family firms predominate in most countries whose industrial histories are short. We therefore chose the countries enumerated above not because we believe they are more important, but because they all have reasonably long histories as industrial economies. Countries whose industrial histories go back only a generation or two, such as Korea, Malaysia, and Singapore, provide insufficient time for the forces that change corporate governance to act. While these countries are profoundly interesting from many perspectives, they are less able to provide insight into the evolution of corporate control than older industrial economies.

The authors of each study were invited to write a historical account of the evolution of control over their assigned country's large firms. The focus is primarily on large firms, for small firms everywhere tend to have controlling shareholders. Mom-and-pop stores in India, Italy, and the United States all tend to be owned by mom and pop. The different connotations of capitalism that spice political debates in different countries so differently are mainly due to differences in who controls countries' large corporations.

This section now summarizes the key results of each chapter. The next section condenses these findings into a general account of how corporate governance diverged as it did.

Canada

In chapter 1, Morck, Percy, Tian, and Yeung describe Canada's preindustrial history—first as a French colony of resource extraction built around the fur trade, and then as first a French and then a British colony of settlement. Their theme is how the institutions built up during these colonial periods affected Canada's subsequent industrial development.

This study has two key points. The first is that Canada was a remarkably corrupt country until a few generations ago. Canada inherited from her French colonial history a disposition to mercantilist policies that invite official abuse. Indeed, the country was a veritable laboratory for Jean Baptiste Colbert, the father of French mercantilism. Subsequent British and Canadian elites preserved this disposition in the Canadian government, economy, and culture.

Their second key point is a remarkable pattern in Canadian corporate control. A full century ago, the large corporate sector looked much as it does now: a slight predominance of family-controlled pyramidal business groups supplemented by a large phalanx of freestanding widely held firms. However, half a century ago, the Canadian large corporate sector was composed mainly of freestanding widely held firms.

Through the first half of the twentieth century, wealthy Canadian families sold out into stock market booms, went bankrupt during recessions, diluted their stakes by issuing stock to fund takeovers, and liquidated corporate empires to pay estate taxes. The net effect was a marked eclipse of family control and pyramids. By the mid-twentieth century, Canada looked much like the United States does in Figure 1. Then, in the late 1960s and early 1970s, pyramidal groups resurged, and they had regained their gilded-age proportions by the century's end. The reasons for this are not fully clear. The authors speculate that an emasculation of the estate tax and a dramatic expansion of state intervention in the economy may have been factors. The erosion of the estate tax permitted large fortunes to survive and grow. Government intervention made political connections more valuable corporate assets than in the past, and pyramidal business groups may have been better than freestanding, widely held, and professionally managed firms at building and exploiting such connections.

Siegal's discussion of this chapter introduces an especially insightful division of institutional development into three stages. First come institutions, such as universal education, necessary for the production of entrepreneurial ideas. Then come institutions, such as financial systems, necessary to realize these ideas. Finally come institutions, such as public policy regarding inheritances, that prevent one period's entrepreneurs from entrenching themselves and blocking entrepreneurship by others.

China

Chapter 2, by Goetzmann and Köll, examines Chinese corporate governance in the late nineteenth and early twentieth centuries. This period is of interest because it corresponds to the beginning of China's industrialization and sees the attempted transplanting of Western institutions into a non-Western economy. Pre-Communist China's industrial development may thus offer more interesting lessons for modern emerging economies than does post-communist China, scraped clear of its non-Western traditions by decades of totalitarian Marxism. Certainly, for China herself, prerevolutionary capitalism also provides a model of a "market economy with Chinese characteristics."

Late nineteenth-century China's first generation of industrial firms floated equity yet remained under state control. Modeled on the imperial salt monopoly, these ventures were financed and operated by private merchants, but ultimately controlled by imperial bureaucrats. Intended to reassert China's pride and prestige, they sought to free China of foreign arms makers, shippers, and manufacturers. Industrialization was a means to this end, and to restoring China's traditional economic balance, but not an end in itself.

Imperial bureaucrats were accustomed to buying and selling offices and favors. Profitable businesses thus attracted more intensive bureaucratic oversight, and their earnings were quickly bled away. Although bureaucratic intervention protected these firms from competition, their merchant investors and managers became increasingly dissatisfied with the fees and bribes their civil service overlords demanded.

Having lost the Sino-Japanese War in 1895, the imperial government was forced to permit private foreign industry in treaty ports, which were subject to foreign law, and so could no longer prevent Chinese from establishing private industrial firms. New industrial businesses proliferated rapidly.

To regulate these, the imperial government enacted a new Corporations Law in 1904. An abbreviated version of contemporary English and Japanese law, it permitted limited liability and mandated shareholder meetings, elected boards, auditors, and detailed annual reports. Shares had traded in Shanghai since the 1860s, and equity participation was a long-established business principle. The 1904 code was thus a top-down revision of established practices, not a de novo introduction of business corporations. Its main innovation was the replacement of official patronage by a rules-based code of conduct designed to attract investment by public shareholders.

It was remarkably ineffective. Goetzmann and Köll examine a large industrial concern, Dasheng No. 1 Cotton Mill, to see how the 1904 law altered its governance and find virtually no effect. The founder and general manager, Zhang Jian, continued intermingling company and personal funds, ignored shareholder criticism of his donations of company money to political causes, and could not be removed because the corporate charter contained numerous provisions protecting his power. The absence of standard accounting rules made the disclosed financial accounts of minimal use.

The reasons beneath this failure are not fully clear. Perhaps cultural inertia prevented real change, and China's long culture of family business paying for the patronage of imperial bureaucrats proved too deeply ingrained. But the top-down reformers also saw capital markets only as sources of funds, overlooking their use as mechanisms for disciplining errant corporate insiders. Portfolio investors, unable to influence corporate governance after the fact, moved out of stocks. This kept the Chinese stock market illiquid and subject to severe boom-and-bust cycles. This, in turn, kept insiders from selling out and diversifying, underscoring the value of their private benefits of control.

In his discussion of this chapter, Perkins argues that China's traditional legal system was also an important factor. By empowering each county's magistrates as representative of the central government, judge, and prosecutor, this system prevented the disinterested enforcement of any laws, no matter how well written. Perkins stresses that the real lesson modern emerging economies should take from pre-Communist Chinese economic history is the critical importance of an independent and trustworthy judiciary.

France

The chapter on France by Murphy (chap. 3) stresses the importance of history. Its theme is that historical trauma generates strong aftershocks that affect the economy for generations, shaping the collective psyche to constrain the course of subsequent events. This chapter is an eloquent restatement of "path dependence"—the thesis that a simple historical accident can set the economy on one of many previously equally probable paths.

The shock that set the course of future French corporate governance was the implosion of the Mississippi Company in 1720. John Law (1671–1729), a Scottish convicted murderer, rescued France from the financial ruin wrought by the wars and court extravagance of Louis XIV. Law's Compagnie de l'Occident took on all French government debt in return for a monopoly on trade with Louisiana. Law's company issued shares and hyped their value, stimulating investment demand, which pushed their value up further, stimulating even more demand.

This bubble imploded in 1720, ruining the finances not only of the French kingdom but of much of her aristocracy and merchant elite. Joint stock companies were banned, and wise Frenchmen shunned financial markets and passed this wisdom on to their children.

The South Sea Company, a deliberate imitation of Law's French experiment in Britain, burst at about the same time and to somewhat the same effect. The Bubble Act of 1722 banned joint stock companies in Britain unless they secured a parliamentary charter. This meant that establishing each new joint stock company required an act of Parliament. The London Stock Exchange survived because preexisting sound British companies, such as the British East India Company and the Hudson's Bay Company, were grandfathered.

The reaction in France was much more severe—a profound rejection of banks, credit, and financial innovation and a retreat to the traditional French financial system, regulated by religious directives, which controlled methods of borrowing and lending, with the state constituting the main borrower. Religious prohibitions against interest meant that contracts had to separate the ownership of savings from the streams of revenue they produced. The notaries who drew up these contracts became surrogate bankers, but only in a very limited sense. While they arranged for the state to borrow by issuing annuities, Murphy argues that their role in financing the private sector was mainly limited to mortgages for real estate purchases. While they had some leeway around the usury laws, the notaries were unable to arrange the sorts of high-interest speculative debt appropriate to finance an industrial revolution. British companies needed parliamentary approval to issue shares, but French businesses had even more difficulty issuing shares, had no access to debt in the ordinary sense, and had to get by without a formal banking system.

In October 1789, the revolutionary government repealed the usury laws and resurrected Law's economic system, now issuing *assignats.* The only real difference was that these securities were backed by seized church estates, rather than a monopoly on trade with Louisiana. John Law was a central topic in the National Assembly debates. Murphy describes how the Abbé Maury produced a fistful of Law's banknotes, denouncing them as "fictive pledges of an immense and illusory capital, which I drew from a huge depot where they have been held for the instruction of posterity. With sorrow I look at these paper instruments of so many crimes, I see them still covered with the tears and blood of our fathers and I offer them today to the representatives of the French nation as beacons placed on the reefs so as to perpetuate the memory of this massive shipwreck."

Maury was ignored, and the Revolutionary government issued ever more *assignats* to cover its escalating expenses. France soon experienced full-blown hyperinflation and financial collapse. Kindleberger (1984, p. 99) writes that *assignats* "embedded paranoia about paper money and banks more deeply in the French subconscious."

The hyperinflation nourished the popular distrust of finance that Law had sown, and the French public took to hoarding gold and silver. Through most of the nineteenth century, most transactions were in specie, and coins still composed more than half of the money supply in 1885.

The French banking system was reinvigorated with the rise of the Crédit Mobilier, a universal bank established by Emile and Isaac Pereire, inspired by the utopian socialist ideals of Claude-Henri, comte de Saint-Simon, who saw banks as irrigation systems to bring capital from areas of overabundance to areas of drought. Hobbled by a portfolio of disastrous investments, the Crédit Mobilier collapsed in 1867, taking much of the French and European banking system down with it, and wise Frenchmen continued hoarding gold and silver coins.

The Paris bourse would occasionally achieve brief periods of activity in the late nineteenth and early twentieth centuries, but it would never again rival the economic importance of the London Stock Exchange. Kindleberger (1984, p. 113) estimates that "France lagged behind Britain in financial institutions and experience by a hundred years or so."

French businesses expanded, using the retained earnings of one company to build others, and the founding families of these business groups remained in control generation after generation. French Civil Law facilitated this course by making it virtually impossible for the owner of a business to bequeath it to anyone but his children. French tycoons with families cannot leave their fortunes to charitable foundations. Landes (1949) argues that France fell behind Britain because a preponderance of family control made large French corporations more conservative and reliant on government connections.

Severe financial trauma thus set France on a course of economic development that left wealthy families controlling her corporate sector under the watchful guidance of the state. Psychologists have only the vaguest understanding of why a similar trauma shatters some individuals' lives and barely affects others. Economists, likewise, need a deeper understanding of how economic trauma shapes institutional development. Murphy's chapter is a first step in that direction.

Daniel Raff, in his discussion of this chapter, raises a series of penetrating questions arising from Murphy's central ideas, and argues that we need much additional work along these lines.

Germany

In chapter 4, Fohlin argues that Germany's large universal banks were less important to its history of corporate governance than is commonly believed. German industrialization advanced rapidly in the late nineteenth century, financed by wealthy merchant families, foreign investors, small shareholders, and private banks. Industrial firms with bankers on their boards did not perform better than other firms.

German corporate governance appears thoughtfully developed in this era. The Company Law of 1870 created the current dual-board structure explicitly to protect small shareholders and the public from self-serving insiders. It also required greater uniformity and consistency in accounting, reporting, and governance. The Company Law of 1884 proscribed sitting on the same company's supervisory and management boards and thrust a "duty to become informed" on supervisory board directors. In the two decades before World War I, managerial turnover was highly sensitive to firm performance, suggesting that some form of disciplinary governance mechanism was functioning. Firms listed in Berlin stock exchange, which were most likely to be owned mainly by public shareholders, rather than founding families or other block holders, replaced management even more readily in response to poor performance.

German universal banks' proxy-voting powers arose from their role in placing new securities and in lending with shares as collateral. The Company Law of 1884 required a minimum turnout at a company's first shareholders meeting, and banks could accomplish this by holding proxies for small shareholders. Banks thus ended up voting the shares of companies that used their underwriting services. The Company Law of 1897 made exchange trading cumbersome, and this apparently moved share trading inside the big banks.

Under the Weimar Republic, ownership seems to have grown more dispersed, instilling fears of corporate takeovers in both founding families and their hired managers. To prevent such events, multiple voting shares and voting caps came into widespread usage.[4] Multiple voting shares were often bestowed on family members serving on supervisory boards and on the family's bank. Voting caps cap nonfamily shareholders' voting rights regardless of their actual ownership. Pyramids do not seem to have gained prominence, perhaps because these other devices permitted firms to tap public equity markets for capital without risking takeovers.

The National Socialist government established much of the modern foundations of German corporate governance. Invoking the *Führerprinzip* or *leader principle,* the Nazis' Shareholder Law of 1937 freed corporate managers and directors of their specific fiduciary duty to shareholders and substituted a general duty to all stakeholders—especially to the Reich. It banned voting by mail, and forced shareholders who could not vote in person to register their holdings with banks and entrust banks with proxy voting rights. This bestowed the large banks with voting control over much of the German large corporate sector. The Reich then took control of the banks.

Following the war, the banks were privatized, but the Nazi innovations of stakeholder rights and proxy voting by banks remained. Codetermination gave workers half the supervisory board, though Roe (2002) argues that companies simply shifted decisions out of the supervisory boards. Reforms in 1965 abolished the *Führerprinzip,* required banks to have written permission to vote proxies, and required that banks inform shareholders of how they voted. Shareholders could be anonymous again. Reforms in 1998 abolished voting caps, and the stock prices of affected companies rose sharply. Multiple voting shares remained unimportant.

Pyramiding apparently arose mainly after WWII. German households' ownership of shares declined sharply, from 48.6 percent of all shares in

4. Though Dunlavy (2004) argues for a much earlier provenance.

1950 to 17 percent in 1996. Meanwhile, intercorporate equity blocks rose from 18 percent in 1950 to 41 percent in 1996. The use of pyramids is far more extensive in the last few decades of the twentieth century than before. With multiple voting shares banned, pyramids may have become the preferred mechanism for retaining control while also using public shareholders' money.

The modern German economy thus consists primarily of family-controlled pyramidal groups and nominally widely held firms that are actually controlled by the top few banks via proxies. The leading banks collectively also control dominant blocks of their own shares. Bank voting control is less evident in smaller firms, which tend to have family control blocks. Recent reforms require banks to inform shareholders of their right to vote their own shares annually and to erect Chinese Walls around staff who decide how to vote at shareholder meetings.

Fohlin argues that patterns of corporate control in Germany are best explained by "a string of disastrous political institutions and movements in the aftermath of World War I, culminating in the Nazi regime, dismantled the rich, highly functioning, hybrid financial system of the Second Reich. The postwar political and legal climate, one that continues to suppress the liberal tradition of the pre–World War I era, seemingly prevents the old dual system from reemerging."

Dyck's discussion commends Fohlin for documenting the aborted dispersion of German shareholdings, but argues that a complete explanation needs further work. Dyck is unswayed by arguments diminishing the role of banks in German corporate governance, and argues that Germany's economic success warrants further study of how German firms avoid classic governance traps.

India

Chapter 5, by Khanna and Palepu, highlights India's long business history. Large-scale trading networks of merchants belonging to particular ethnic and sectarian groups go back centuries, and modern Indian business groups often correspond to these same groupings. When India began industrializing under the British Raj, these groups had the capital both to compete and to cooperate with Indian subsidiaries of the great British business groups of the era.

The Tata family, of priestly Parsi origin, controlled the largest business group in India for the past sixty years. The group grew to prominence under the Raj, nurtured by colonial government contracts and protected by imperial tariffs. The Tatas were neutral on independence, and so they lost favor when the Congress party took charge.

The Birla family, of the prosperous Marwari community, financed Mohandas Gandhi and the Congress party generously. Khanna and Palepu quote Sarojini Naidu, a Congress activist and poet, who quipped, "It took all Birla's millions to enable Gandhi to live in poverty. And he gave for free." The Birla group expanded dramatically in the postindependence period and by 1969 was the second largest Indian business group.

Thus, the early histories of India's two greatest business groups align with two theses of Ghemawat and Khanna (1998) and Khanna (2000): that such groups excel at doing deals with politicians and attain their position through political connections, and that they confer genuine economic advantages. Khanna and Palepu's finding that group firms are typically older and larger than independent firms is consistent with both.

Khanna and Palepu's key point is that the rankings of smaller Indian business groups are quite volatile, with groups appearing, rising, falling, and disappearing. Turnover around independence doubtless reflects the withdrawal from India of British business groups such as Martin Burn, Andrew Yule, and Inchcape. But volatility actually increases after independence, clearly showing that business groups did not always entrench their owners' economic positions. Such volatility speaks of a more entrepreneurial economy than is generally credited to postindependence India.

Thus, business groups as an organizational form persisted, but many individual business groups, especially smaller ones, did not. In the 1960s, Prime Minister Jawarharlal Nehru led India down a distinctly socialist path, building a dense thicket of regulation and bureaucratic oversight that came to be called the License Raj. Nehru's original motive seems to have been a desire to curb the power of India's large business groups following a series of official reports that documented evidence of big business houses exerting significant influence over the economy and exploiting growth opportunities through favorable access to finance and government permits. Nehru's daughter, Prime Minister Indira Gandhi, asserted even greater state control over private-sector firms' pursuit of growth opportunities, access to finance, and collaboration with foreign partners and forced many multinational companies out of the country. This policy proved economically disastrous, and a period of slow deregulation began in the mid-1980s. A financial crisis spurred a much more radical liberalization in the 1990s.

Turnover among smaller business groups during all of this might indicate an entrepreneurial economy, in which innovative new businesses arise and old ones die out. Khanna and Palepu argue that business groups retained an advantage over individual firms throughout because they could better bridge institutional gaps—like dysfunctional capital, labor, and product markets. But these benefits certainly accrue mostly to very large business groups. Smaller ones containing only a few firms cannot avoid markets as well as huge groups containing larger reservoirs of capital, labor, and products of all kinds that can be allocated internally.

But the larger groups also devoted huge resources, establishing de facto embassies in New Delhi staffed by legions of experts in all manner of bureaucratic red tape. The License Raj was clearly constructed to tie down the great business groups, but its actual effect may have been the opposite. Only the largest groups could absorb the huge fixed cost of retaining the bureaucratic expertise needed to navigate the maze.

Under Indira Gandhi, the Birla group was accused of manipulating the licensing system. Stung by this unexpected criticism, the Birlas shifted their expansion plans overseas. Given India's strict foreign exchange controls at the time, this surely required official acquiescence. A string of profitable overseas subsidiaries put substantial group cash flows well beyond the reach of the minions of New Delhi, enabling the group to expand rapidly within India once the License Raj was dismantled. One interpretation of all this is that the size and prominence of the Birla group reflects their entrepreneurial tendencies in handling the licensing restrictions, rather than simple political rent seeking.

The Tatas felt discriminated against under the License Raj, and this may well have been so. Nonetheless, they survived and prospered, and grew increasingly entrepreneurial and innovative to compensate for their relative lack of political influence. By remaining economically dominant, the Tata group confirms that government connections are but one factor underlying the success of Indian businesses.

Ultimately, the chapter argues that large family business groups likely persisted because they bridged institutional voids created by dysfunctional markets and weak economic institutions. But even beyond this, the chapter argues that the Tata group in particular survives and prospers because of genuine entrepreneurship. They stress the role of the Tatas in developing India's software industry. This industry is thought to prosper precisely because it is less dependent on India's creaking domestic institutions and markets, so groups' advantage in this sector should be minimal. Perhaps the Tatas supply entrepreneurial activity and prosper because this is in short supply in emerging economies like India.

Mody's discussion of this chapter begins with a comparison of Korea, whose development depended on large family-controlled business groups, and Taiwan, whose development was mainly due to smaller firms. He points out that both countries grew rapidly, but he suggests that Korean groups eventually became a problem because they made entrepreneurship by outsiders difficult. Mody recounts the Bombay Plan, in which the leaders of India's most powerful business families "called on government support for industrialization, including a direct role for the government in the production of capital goods, foreshadowing postindependence Indian planning, typically considered an outgrowth of socialist ideas drawn either from the Soviet Union or the so-called Fabian socialists." He argues that this plan, proposed just before independence, shows that its sponsors, including the Tata and Birla families, did actively seek partnership with the Congress party government they saw approaching.

Italy

Chapter 6, by Aganin and Volpin, shows that family-controlled business groups were more powerful in the middle of the century than at either end of it, and that the stock market was more important at either end of the century than at its midpoint.

Laws and politics clearly have some explanatory power. At the beginning of the century, the Italian government had little interest in direct intervention in the economy. However, all three major Italian investment banks collapsed in 1931, and the Fascist government took on their holdings of industrial shares and imposed a legal separation of investment from commercial banking. The shares were turned over to the Istituto per la Riconstruzione Italiana (IRI), which would persist as a large state-controlled pyramidal group. After the Second World War, Italy's governments maintained a direct role in the economy, propping up financially troubled companies and using its corporate governance power to direct economic growth, especially in capital-intensive sectors. Postwar governments founded the Ente Nazionale Idrocarburi (ENI) in 1952 to control firms in the chemical, oil, and mining sectors; the Ente Partecippazioni e Finanziamento Industrial Manifatturiera (EFIM) in 1962 to control electric and other companies; and the Società di Gestioni e Partecipazioni Industriali (GEPI) in 1972 to intervene in the Southern Italian economy. Each of these business groups controlled numerous listed companies and was directed by a forceful, politically appointed CEO.

Aganin and Volpin thus argue that, since postwar Italian politicians opted to allocate capital via an industrial policy rather than via the financial system, they saw no great need for investor protection. Investors opted for government bonds, rather than shares, and the Italian stock market shrank steadily through the middle of the century. New entrants found public share issues very expensive, while politicians assisted established large business groups with cheap capital. New publicly traded family groups emerged rarely, and always with strong political support. Most Italian firms remained unlisted and were operated by founding families in small-scale niche markets.

This locked in a sort of *state and family capitalism.* Listed firms were mostly organized into pyramidal groups controlled by either the state or old families. The corporate governance of Italy's large listed firms was thus entrusted either to politically appointed bureaucrats or to wealthy old families who transmitted power from generation to generation.

Italy's industrial policies directed subsidized capital to both sorts of business groups, which raised public debt and taxes to unsustainable levels by the 1990s. A sweeping privatization program and improved legal protection for public shareholders reinvigorated the stock market. Formerly unlisted companies opted to go public, and the stock market grew further.

Investors, increasingly conscious of the need for good corporate governance, continue to demand stronger property rights protection.

Japan

The history of corporate governance in Japan is more complicated and variegated than in any other major country. Consequently, chapter 7, by Morck and Nakamura, takes the form of a narrative history more than do many of the other contributions to this volume.

Prior to 1868, Japan was a deeply conservative and isolationist country. Business families were at the bottom of a hereditary caste system—beneath priests, warriors, peasants, and craftsmen. Unsurprisingly, this moral inversion led to stagnation. Yet the necessity of running a densely populous country forced Japan's feudal shoguns to give prominent mercantile families, like the Mitsui and Sumitomo, steadily greater influence.

When Admiral Perry, in an early example of American unilateralism, bombarded Tokyo until Japan opened her markets to American traders, the shogun acquiesced and a cadre of rash young samurai warriors seized power, justifying their coup as the restoration of the Meiji emperor, who nonetheless remained a figurehead. The Meiji Restoration leaders planned to defeat the foreigners and restore Japan's splendid isolation, but they soon realized that beating the foreigners meant learning their ways. The Meiji leadership sent Japan's best students to universities throughout the world to learn about foreign technology, business, and governments, and to report back. The result was a cultural, economic, and political reinvention of Japan, in which the reformers cobbled together a new system based on what they saw as global best practice in legal, economic, and social institutions. The government founded state-owned enterprises to bring all manner of Western industry to Japan, and built up huge debts in the process. To extricate itself, the Meiji government conducted a mass privatization, in which most of these enterprises were sold to the Mitsui and Sumitomo families and to a few other family-controlled business groups that were gaining prominence, such as Mitsubishi. These groups, called *zaibatsu,* were family-controlled pyramids of listed corporations, much like those found elsewhere in the world. Later, other groups like Nissan, a pyramidal business group with a widely held firm at its apex, joined in as Japan's economy roared into the twentieth century. Thus, Japan began its industrialization with a mixture of family and state capitalism. Shareholders eagerly bought shares, especially in numerous subsidiaries floated by these great business groups.

The 1920s and early 1930s were depressionary periods and exposed the weaknesses and strengths of different pyramidal structures. Groups like the Mitsui, Sumitomo, and Mitsubishi pyramids, whose banks (or de facto banks) were located near their apexes, survived. Groups like the Suzuki pyramid, whose bank was controlled but not owned by the Suzuki family, failed. It seems likely that the Suzuki structure disposed the controlling family to transfer funds out of the bank and into firms whose financial fate affected family wealth, and that this rendered such groups financially unstable during downturns. The prolonged economic stagnation eroded the public's appreciation of family capitalism, and economic reformers lambasted the wealthy families for putting their rights as shareholders ahead of the public interest and for their fixation on short-term earnings and dividends rather than long-term investment.

In the 1930s, the military slowly consolidated power by strategically assassinating civilian government leaders and replacing them with military officers. Although Japan's military government was decidedly fascist, its economic policies borrowed unblushingly from Soviet practices. The government freed corporate boards of their duty to shareholders—meaning the families and corporate large shareholders—and limited dividends. Military representatives sat on all major boards and supervised the implementation of centrally directed production quotas. Prices and wages were also determined by central planners. Although the de jure ownership rights of Japanese shareholders were never formally annulled, the 1945 American occupation force took charge of an economy not greatly different from the post-Socialist economies of Eastern Europe in the early 1990s.

The American occupation government, though led by General MacArthur, was staffed with Roosevelt "New Dealers." As the chapter by Becht and De Long shows, the Roosevelt administration had successfully forced the dismantlement of America's *zaibatsu,* the great family-controlled pyramidal groups that had previously dominated its economy. The New Dealers resolved to do the same in Japan. Family and intercorporate equity blocks were confiscated and sold to the public. The families received nominal compensation in bonds, and the proceeds from the equity sales accrued to the government. By 1952, Japan's great corporations were almost all freestanding and widely held, just as those of the United Kingdom and United States are at present. Corporate raiders soon emerged and launched two major waves of hostile takeovers of firms they viewed as misgoverned. As in the United Kingdom and United States today, hostile takeovers were only a small fraction of total merger activity, but they affected large firms and drew disproportionate publicity. As Morck, Shleifer, and Vishny (1988) stress, the threat of a hostile takeover is probably more important to promoting good governance than its occurrence.

But takeovers did not lead to the improved governance the raiders desired. The professional managers now governing Japan's great corporations were not constrained by regulations, laws, or customs to protect the property rights of public shareholders. Initially, a popular takeover defense was *greenmail*—the target firm's managers would pay the raider (with shareholders' money) to back off. These payments likely only emphasized the target firms' poor governance to other potential raiders.

Ultimately, a more effective takeover defense was devised—the *keiretsu.* In the United States, target firms sometimes obstruct a raider by placing a block of stock with a friendly shareholder, called a *white squire,* or by bringing in a rival acquirer, a *white knight,* whose management is friendly to the target's managers. The *keiretsu* defense, a variant along the same lines, involves a group of firms run by mutually friendly managers exchanging small blocks of stock with each other. Even though each firm holds only a tiny stake in every other firm, these stakes collectively sum to effective control blocks. Every firm in the *keiretsu* group is thus controlled collectively by all the other firms in the group. *Keiretsu* groups arose in two waves, first in the 1950s and then in the 1960s. Japan's experiment with Anglo-American shareholder capitalism was short-lived, and the *keiretsu* system remains in place today.

Although their primary functions were to lock in corporate control rights, both *zaibatsu* and *keiretsu* were probably also rational responses to a variety of institutional failings. Successful *zaibatsu* and *keiretsu* were enthusiastic political rent seekers, raising the possibility that large corporate groups are better at influencing government than freestanding firms. In the case of some *zaibatsu* and many *keiretsu,* this rent seeking probably retarded financial development. This, and the probable misallocation of substantial amounts of capital by poorly governed *keiretsu* firms, appears to have created long-term economic problems that slowed Japan's growth through the 1990s.

Sheldon Garon's discussion argues that more attention should be paid to precisely who made which decisions in importing Western institutions. He also points out that little is said in the chapter about small and medium-sized firms, despite their importance. He also takes issue with the view that Tokugawa Japan isolated itself from the rest of the world and that Japan's wartime economy resembled Soviet central planning. He points out that recent thinking stresses Tokugawa Japan's contacts via foreigners in Nagasaki and rightly argues that wartime Japan imitated National Socialist central planning, which is described in detail in the chapter by Fohlin. We recognize this but remain impressed by the remarkable similarity of National Socialist, Fascist, and Soviet socialist central planning, as described by Silverman (1998), Guerin (1945), and Hosking (1985), respectively, among others.

The Netherlands

The Netherlands has the oldest stock market in the world, and its entrepreneurs largely invented the joint-stock corporation. Chapter 8, in which de Jong and Röell discuss the history of corporate governance in the Netherlands, is therefore especially enlightening. The world's first great limited-liability, widely held, joint-stock company, the Dutch East Indies Company, or Vereenigde Oostindische Compagnie, was founded in 1602.

The world's first great corporate governance dispute quickly followed in 1622, when the managers, who had floated the stock as participation in a limited-term partnership with a liquidating dividend in twenty years, decided to keep the "astonishingly lucrative" enterprise continuing indefinitely. The investors were outraged, but the government of the Dutch Republic saw the company as a weapon in its conflicts with Spain and supported management. The dividend stream was large enough that investors who wanted out could sell their shares to others. This was perhaps better than a liquidating dividend since the seller need not wait for the company's fixed lifetime to expire. Nonetheless, vociferous shareholder complaints about inadequate disclosure and dividend payouts continued and are preserved in the company archives. Other widely held firms followed suit, and the Dutch stock markets remained Europe's financial heart for a century.

Among other things, spillovers from the series of French financial crises, which Murphy discusses in chapter 3, undermined Dutch investors' confidence in financial markets—slowly through the eighteenth century, and then quite rapidly during the French occupation (1795–1813). In 1804, the French imposed a version of their civil code. This was widely viewed as less sophisticated than the indigenous legal system. It jettisoned two centuries of Dutch accumulated legal wisdom and inflicted French investors' aversion of financial markets upon the Netherlands. The French civil code, along with a public debt (bequeathed by the French administration) of more than four times national income, and a prolonged industrial dislocation caused by the carve-out of Belgium as a separate state, made the first part of the nineteenth century a period of slow growth.

Industrial development in the second half of the nineteenth century was financed mainly with retained earnings from family firms that had slowly accumulated wealth over the previous half-century. Wealthy families often bought into new firms' commercial paper, or *prolongatie,* and were expected to roll these investments over indefinitely. Listed domestic shares played a role toward the century's end, but repeated egregious looting of listed companies by insiders limited public investors' appetites. Many small Dutch investors, whose families had lost heavily in the official defaults of the French revolutionary era, apparently preferred to save by hoarding coins. Although Dutch markets were energetic throughout the nineteenth century, their most active listings were foreign government bonds and American railroad and industrial stocks.

During the twentieth century, a clear trend away from family control and toward professional management is evident. Public equity issues and long-term bank loans played an important role in an industrialization boom from 1895 to roughly 1920, reinvigorating the stock markets. Unlike Germany, the Dutch kept bankers to a secondary role in the governance and financing of industrial firms. Workers' corporate governance voices grew louder in the final decades of the twentieth century, but they remain more muted than in Germany.

Despite the rise of public equity participation in Dutch firms, de Jong and Röell conclude that real decision-making power remains with self-perpetuating top corporate executives, entrenched behind formidable takeover defenses. These defenses differ from those in Anglo-American finance and so merit mention. Reforms emulating German codetermination mandated that companies establish supervisory boards but gave shareholders no real role in choosing their members. These self-perpetuating supervisory boards thus severed managers' responsibility to shareholders. Another entrenchment device is *priority shares,* to whose owners are relegated key corporate governance decisions, such as board appointments. Other so-called *oligarchic devices* relegate power over key decisions, like payout policies, to organs other than the management board. Voting caps, restricted voting shares, and super-voting shares are also widely used. From the end of World War II through the 1970s, another popular entrenchment device was *preference shares,* issued to white squire shareholders at deep discounts and often carrying superior voting rights. Yet another device is to place all voting shares with an income trust and then let public investors buy units in that trust. Finally, interlocking directorships are commonplace, apparently giving the Dutch corporate sector a clubby air.

De Jong and Röell find that these devices are associated with depressed shareholder value. Many of these entrenchment devices have come (or are) in conflict with European Union directives, and they suggest that other entrenchment devices, like pyramidal groups, will grow more popular in their place.

Högfeldt's discussion compares the Netherlands to Sweden, stressing the remarkably reticent role of Dutch banks compared to Swedish ones, the remarkable array of takeover defenses in Dutch listed firms, and the apparent acquiescence of Dutch politicians to these defenses.

Sweden

Swedes are justly proud of their unique model of highly egalitarian social democracy. Yet chapter 9, by Peter Högfeldt, shows that Swedes also entrust their wealthiest families with an extraordinary concentration of corporate governance power.

Högfeldt argues that this concentration occurs because of persistent Social Democratic political influence, not despite it. The Social Democrats became de facto guarantors of family capitalism because of a surprising commonality of interests. Social Democratic politicians wanted a stable large corporate sector controlled by Swedes, who were thought more susceptible than foreign owners to political pressure and hence more likely to buy into Social Democracy eventually. Sweden's wealthy families, who used small blocks of super-voting shares to hold together their vast pyramidal business groups, wanted to preserve the status quo. Buying into Social Democracy apparently seemed a reasonable price for policies that locked in their corporate governance powers.

Högfeldt argues that the extensive separation of ownership from control in these pyramidal structures makes external financing expensive relative to retained earnings, and so encourages existing firms to expand and discourages new firms from listing. He calls this a political pecking order theory of financing. To this, the Social Democrats added tax subsidies for firms that finance expansions with retained earnings and heavy taxation of returns to public shareholders.

These entrenched mutually supportive political and corporate elites provided Swedes solid growth until the 1970s, when the economy proved unexpectedly inflexible in dealing with external shocks. Institutions designed to stabilize the largest firms and prevent upstarts from arising to challenge them were ill suited to dealing with a rapidly shifting comparative advantage in the global economy. Social Democracy had redistributed income dramatically but could not manage the necessary redistribution of property rights and wealth.

The result, according to Högfeldt, is an increasingly frail economy dominated by elderly and infirm companies, still controlled by the same wealthy families that bought into the Social Democratic experiment more than half a century ago.

Röell's discussion stresses the differences between Sweden and the Netherlands—both small, northern European social democracies. She argues that voting caps and other residues of Napoleonic civil law entrenched insiders in the Netherlands while dual class shares and pyramids entrenched Swedish insiders. Both sorts of entrenchment are costly, and tallying up these costs is an important research problem.

The United Kingdom

The chapter on the United Kingdom by Franks, Mayer, and Rossi compares a cadre of firms founded in 1900 to another founded in 1960. The authors find that ownership grows diffuse in both sets of firms at roughly the same rate. Based on this, they argue that the forces that made founding families withdraw from corporate governance in the modern United Kingdom also operated a century ago.

They argue that shareholder rights in the United Kingdom were extremely weak until the latter part of the twentieth century and so dispute the contention of La Porta et al. (1999) that shareholder legal protection permits diffuse ownership in the United Kingdom. If this were true, they argue that corporate ownership should have been highly concentrated earlier in the century, which they do not observe.

Providing a descriptive summary of United Kingdom corporate governance in greater generality, they further argue that pyramids gained importance at the middle of the century. They suggest that improved corporate disclosure, implemented in 1948, made hostile takeovers less risky for raiders, and that pyramids developed as a defense against hostile takeovers. However, they argue that institutional investors saw serious governance problems in these structures and lobbied to have them undone. British institutional investors successfully pressed the London Stock Exchange to adopt a takeover rule whereby any bid for 30 percent or more of a listed firm must be a bid for 100 percent. Franks et al. propose that this rule made pyramidal business groups untenable as takeover defenses and that continued pressure from institutional investors on boards rapidly rid Britain of these structures.

Franks et al. also argue that concentrated corporate control and pyramidal groups are of more value to insiders elsewhere than in Britain. This is because these ownership structures permit corporate insiders to extract private benefits of control. However, they propose that British corporate insiders were and are governed by higher standards of ethical conduct, which preclude the extraction of such private benefits. Given this, British corporate insiders were more readily convinced to sell their control blocks and dismantle their pyramids. Thus, the current diffuse ownership of British corporations came to prevail early in the twentieth century and still persists.

Eichengreen's discussion raises further questions. The Great Depression was a critical juncture in the evolution of corporate governance in many countries, yet it is little discussed. Why were British banks content without the corporate governance powers of their German or Swedish peers? He notes that Sylla and Smith (1995) emphasize the Directors Liability Act of 1890, which made company directors liable for statements in prospectuses soliciting buyers for company shares, and the Companies Act of 1900, which strengthened the principle of compulsory corporate disclosure, as the explanation for why British financial markets developed so rapidly around the turn of the century. He speculates that shareholder rights might have been stronger in early twentieth-century Britain than Franks et al. admit.

The United States

The chapter on the United States by Becht and DeLong explores how that country came to have the atypically diffuse corporate ownership evident in figure 1. The great corporations of other countries are usually organized into business groups that are controlled by wealthy, old families or powerful financial intermediaries. Great corporations in the United States are, for the most part, managed by career professionals and freestanding—they do not have listed subsidiaries or parents.

These differences are developments of the twentieth century, for Moody (1904) describes an America that was more "normal." Powerful banking houses and plutocratic families controlled much of the large corporate sector, wielding their corporate governance power robustly, monitoring, choosing, and replacing managers and setting corporate direction.

But by the 1930s, all of this had changed. A remarkable democratization of shareholding took place between World War I and the end of World War II. The benefits of diversification depend on the depth of the stock market. High-pressure war-bond sales campaigns in 1917–18, popular magazines on share ownership, and popular media coverage of Wall Street celebrities brought middle American wealth into the stock market, vastly deepening it and thus making the sacrifice of control for diversification more attractive than elsewhere.

The burgeoning Progressive Movement deplored both the concentration of economic power and the way business oligarchs like J. P. Morgan, the Rockefellers, and others ruling vast pyramidal groups "turned conflict of interest into a lifestyle." Progressive politicians pilloried the "robber barons" of industry, their heirs, and J. P. Morgan.

Both to obtain the benefits of diversification and to relieve their pummeling by the progressive press, many wealthy families sold majorities of their firms' shares into the stock markets. Of course, most of these families at first retained control through voting trusts, staggered boards, larger and more complicated pyramidal holding companies with multiple classes of stock, and other entrenchment devices.

But progressive politicians were on a roll, and they pressed antitrust regulators into service. In 1911, they succeeded in breaking up the Standard Oil Trust, a huge group of petroleum and industrial companies formerly controlled by the Rockefeller family. Over the subsequent decades, these emerged as freestanding, widely held, and professionally managed entities. Becht and DeLong track this process in detail for Standard Oil of New Jersey.

America's response to the Great Depression then razed much of what *family capitalism* remained. Two great pyramids, the Insull and van Sweringen business groups, collapsed after the 1929 crash. These high-profile collapses appear to have linked the Depression with highly concentrated corporate control in the public mind, justifying a barrage of progressive reform. The Glass-Steagall Act of 1933 pared commercial from investment banking. The Public Utility Company Holding Companies Act of 1935 forbade pyramidal control of utility companies. A series of regulatory reforms governing banks, insurance companies, mutual funds, and pension funds prevented any of these organizations from accumulating any serious corporate governance influence either.

The activist U.S. courts intervened further to keep shareholdings dispersed. For example, in 1957 the Supreme Court ordered the DuPont family to sell its equity block in General Motors to prevent DuPont from obtaining "an illegal preference over its competitors in the sale to General Motors of its products."

Becht and DeLong then explore 1937 data on blockholdings in the top listed 200 U.S. firms. Of these, 24 are subsidiaries in pyramids and only 34 have no controlling shareholder. They explore the history of the last and find that they became widely held when their founding families sold out, either directly or with trust promoters as intermediaries. Some of this might have been market timing—selling stocks for more than their fundamental values during bubbles. Most of it was probably founding families appreciating the value of diversification in a deep stock market. These wealthy families often retained influence on their boards without holding control blocks.

Stung by progressive-era condemnation, they often turned to philanthropy, distancing themselves and their heirs even further from governance issues. Thus, modern Americans associate the names Rockefeller, Harkness, Carnegie, and Guggenheim with the performing arts, universities, and museums, not with the great business groups that built those fortunes.

Activist judges and progressive politicians, aided by fortune, thus effectively entrusted the governance of America's great corporations to professional managers. The Securities and Exchanges Act of 1934 relegated to management control over who can stand for election to boards, and left boards to monitor management. Although the hostile takeovers of the 1980s disrupted this arrangement for some firms, and some U.S. institutional investors are clearing their throats, this situation has kept most American firms freestanding and professionally run ever since.

Richard Sylla's discussion contrasts Becht and DeLong's arguments with those of Dunlavy (2004), who contends that by 1900 American firms were already exceptional in having one-vote-per-share voting rights, giving large shareholders more say in corporate affairs than small shareholders. In Europe, Dunlavy argues, shareholder voting rights were more "democratic" in limiting the power of large shareholders, as was the case earlier in the United States. Sylla notes that Alexander Hamilton proponed such limits on large blockholder votes as necessary to prevent a few large players from dominating corporate policies. We are impressed that Hamilton was clearly more concerned about entrenched large blockholders, not professional managers, abusing small shareholders, as are students of corporate governance in most modern countries other than the United Kingdom and United States.

What Are the Common Factors?

Each chapter highlights the intricate complexity of financial history. Yet there are common threads spanning many countries. This section tracks some of the most visible of these threads and ties them to current thinking about the reasons why corporate governance is so different in different countries.

Accidents of History

The clearest lesson, evident in every chapter, is that "things happen," and constrain what can happen next. The history of corporate governance, like other historical processes, is *path dependent.*

Had France not suffered repeated financial collapses at the hands of John Law, the Revolutionary Assembly, and the Crédit Mobilier, shareholder rights in that country might have solidified much earlier and much harder. Murphy argues that the formation of new joint-stock companies and other large enterprises essentially ceased in France until 1840 and resumed only very slowly thereafter. Other students of European history make similar points—Frentrop (2003, p. 137) writes that "following the experience of 1720, French public opinion developed a violent distaste for anything to do with financial markets." He goes on to argue that "A similar opinion was expressed in the Netherlands." Frentrop argues that the Napoleonic Code, which French armies spread across the continent in the early nineteenth century, carried that distaste, and was far less conducive to large business undertakings than was the previous Dutch legal system. Perhaps accidents of history explain the findings of La Porta et al. (1999) that countries with legal systems based on the Napoleonic Code have stunted financial systems.

Yet other countries underwent financial crises and responded entirely differently. Britain's South Sea bubble closely paralleled Law's Mississippi bubble, and its response, the Bubble Act, hampered equity markets for generations afterward. But sound ventures like the British East India Company and the Hudson's Bay Company sustained a financial sector that soon boasted sophisticated merchant banks.[5] Psychologists puzzle over why some people are devastated by emotional traumas that others recover from on their own. Economists, too, understand little about how crises affect institutional development. The histories in this volume show this to be an important fault in our discipline.

China's stock market, founded in the 1870s, saw the same sorts of manipulation and insider trading that characterized other markets around the world, and collapsed in 1883—and again in 1922. Perhaps these misfortunes pushed China off a path to free market democracy she might otherwise have followed. Chinese capitalism never recovered, shares in Chinese companies grew illiquid, and the faltering free market economy fell to Mao's Socialist revolution.

In 1933, a committee of experts assembled under the Weimar Republic completed its deliberations on separating commercial from investment banking. Had it favored this separation, German banks would have relinquished most of their corporate governance influence over nonfinancial

5. See Kindleberger (1978).

firms, and German capitalism would have developed far differently than it did. However, the committee favored the status quo—possibly because its chairman, Reichsbank President Hjalmar Horace Greeley Schacht feared setting a berserker like Gottfried Feder loose to reform the system.[6] Feder, a founding member of the National Socialist Party and Hitler's banking advisor, was famous for his 1919 *Manifesto on Breaking the Shackles of Interest* and advocated the nationalization of all banks and the total abolishment of interest.

Perhaps China, Germany, Japan, and Italy might have evolved ingrained cultures of shareholder capitalism had they avoided prolonged economic collapses in the 1920s and 1930s—and if Fascism and Socialism had been less entrancing. Had Socialism been less in vogue in the mid-twentieth century, perhaps India, the Netherlands, and Sweden might have gone the route of American corporate governance. If Colbert had been British, the English-speaking world had had a few more financial crises, or Fascism and Socialism had had more persuasive English-speaking advocates, would America and Britain be dominated by large family-controlled business groups?

But concluding that everything is a concordance of accidents is too simple. However satisfying that view to pure historians of individual countries, economic history is about patterns and regularities amid those accidents. Fortunately, many issues that ought to affect corporate governance are already highlighted in the literature. Even more fortunately, the chapters in this volume present a wealth of detail that helps fill in the gaps. It would be wonderful for economists if we could conclude that one theory is correct and discard the others, but economics is rarely so simple. All of the major theories that purport to explain historical and cross-country differences in corporate control find support, though some require modification in passing.

Ideas

Wars, upheavals, and many other catastrophes affected many countries simultaneously but triggered different reactions in different countries—perhaps depending on the popularity or unpopularity of certain ideologies at that point in time. Rarely, as after the English Civil War and American Revolution, private property rights coalesced. Perhaps more typically, French economic and political turmoil in the 1720s resurrected traditional Catholic restraints on business. More turmoil at the end of the eighteenth century institutionalized a suspicion of all things financial, and wars exporting the French Revolution spread this to the Netherlands and elsewhere. The chapters in this book collectively suggest the importance, for good and ill, of ideologies at critical moments when economies are ripe for institutional transformations.

One such critical moment was the Great Depression of the 1930s, when

6. See Kleeberg (1987) for details.

different countries set off in different directions that wrought today's differences in corporate governance. Financial catastrophes in many countries in the 1920s and 1930s, and ideological reactions to them, deeply affected their subsequent evolution of corporate control.

In the 1930s, the United States was deeply influenced by the progressive ideology of Louis Brandeis, Thorsten Veblen, and others. Roosevelt's New Dealers realigned American institutions to this ideology when the Great Depression undermined popular faith in America's older institutions. Dispersing economic power as widely as possible was a key part of this. Thus, the American government undertook to break up that country's great pyramidal corporate groups by banning large pyramidal groups from controlling public utility companies, applying taxes to intercorporate dividends, and strengthening public shareholders' property rights over their investments.[7] This fortuitous coincidence of ideology and opportunity to act created America's exceptional large corporate sector composed mainly of freestanding widely held firms.

In Sweden, the same Great Depression had completely different results. The ideology waiting in the wings in Sweden was Social Democracy. When Swedish voters lost faith in their traditional institutions, Social Democrats took power and radically concentrated economic power in two ways. First, the state assumed power over the commanding heights of the Swedish economy. Second, widespread corporate bankruptcies left large banks, like that owned by the Wallenberg family, holding control blocks in most large Swedish companies. These banks reorganized these companies into the large pyramidal groups that currently dominate the Swedish economy. Högfeldt (chap. 9 in this volume) argues that the Social Democrats and these powerful families developed a symbiotic relationship—the families supported the Social Democrats, who enacted policies that favored large old firms and hampered upstart firms.

Mixtures of Socialist and nationalist ideologies emerged in Germany, Italy, and Japan during the Great Depression. Ultimately, radical nationalists won in all three, but not without adopting many Socialist policies. In the 1920s and 1930s, the major German banks had accumulated huge holdings of their own shares in efforts to stabilize their own stock prices. The National Socialists confiscated these holdings, effectively nationalizing the banks and imposing party control over their proxy voting processes. Multiple voting shares were nullified, except of family firms controlled by gentiles, and voting caps did not apply to banks voting the holdings of individual shareholders by right of proxy. In this way, the Reich de facto nationalized the greater part of the German economy while leaving the formalities of private ownership in place.[8] The Fascist government

7. See Morck (2004b).
8. See Kleeberg (1987, p. 83).

of Italy nationalized the banks, which had seized control blocks in many large bankrupt companies. Italy's postwar governments retained many aspects of Mussolini's economic system, including large pyramidal groups of listed companies with state holding companies at their apexes. Japan's military government likewise placed military representatives on all boards to ensure that large firms were managed patriotically and not for mere profit.

In Canada, socialists and progressives trumpeted opposing visions of reform in the 1930s, letting old-line parties hold the center and retain power. This preserved its prewar system of pyramidal groups. The corporate governance of large Canadian firms changed only gradually over the subsequent decades. Britain, France, and the Netherlands also seem to have preserved their pre-Depression systems of corporate governance.

Another example arises in connection with India and other postcolonial economies. Das (2002) and others argue that intellectual fashions at the London School of Economics adversely affected India's economic policies, including corporate governance. Similar effects elsewhere in the third world seem highly plausible.

Families

A purpose of this book was to provide a richer rendering of corporate governance systems throughout the world. The geographic and chronological scope of the project allows us to make observations as well as raise important questions regarding how enterprise is organized in different parts of the world. Importantly, the book speaks to the neglect of family enterprise relative to its role in capitalist economies. Family capitalism contributes to the wealth and/or poverty of a nation, with appreciation to Adam Smith and David Landes.

A theme throughout this volume is the importance of large family business groups in most developed economies. This confirms La Porta et al. (1999) and Burkart, Panunzi, and Shleifer (2003), who conclude (p. 2167) that most large businesses throughout the world "are controlled by their founders, or by the founder's families and heirs." Moreover, there is no evidence of a uniform natural transition from family capitalism to managerial capitalism. Franks, Mayer, and Rossi's chapter describes such a transition in the United Kingdom, and in chapter 8 de Jong and Röell describe a form of managerial capitalism that is perhaps native to the Netherlands. In chapter 11 Becht and DeLong describe the transition from family to managerial capitalism in the United States as a convolution of accidents and America's unique progressive ideology. In chapter 4 Fohlin shows that, although Germany developed a variant of managerial capitalism because of banking laws left in place by the National Socialists, large family firms and groups remain very important there. Japan's variant of managerialism was a forced postwar transplant of American institutions. In Canada, managerial capitalism displaced family groups through the first part of the century, and then retreated before a resurgence of family groups. Elsewhere, family business groups were seldom challenged except by state-owned enterprises. Professional managers, where they exist at all, are merely hired help employed by enormously wealthy families.

The studies in this volume provide abundant evidence of family control encompassing both best and worst practice. How large family groups perform, and how they affect their economies, seems highly context dependent. Burkart, Panunzi, and Shleifer (2003) stress the legal protection of public shareholders, arguing that heirs relinquish control to better-qualified professional managers and diversify their wealth across many firms only if they trust the corporate governance of those firms, and conclude (p. 2193) that "the separation of ownership and management is thus an indication of a superior corporate governance environment. The lack of such separation, and the prevalence of family firms, is evidence of financial underdevelopment."

But La Porta et al. (1997a, 1998) show that many highly developed economies provide few rights to public shareholders. This might occur naturally if family control offers many advantages. For example, close family bonds might enable a degree of cooperation that is more difficult to sustain among nonkin. Entrusting control over different firms to blood kin might facilitate the transfer of knowledge, roles, and routines from firm to firm as well as from generation to generation. In other words, large family business groups may represent effective ways of organizing enterprises that survive the rigors of economic selection. Khanna and Palepu (chap. 5) stress this naturally cooperative behavior as the glue that holds family groups together and the hard-earned reputations of certain families for their relative success.

But they also show that family business groups rise and fall in India, and other chapters identify analogous change elsewhere. Schumpeter (1951) makes a similar observation about European family enterprises. He posits several factors that alter the relative positions of wealthy families within a ruling class, the breaching of class barriers—upward or downward, and the rise and fall of whole classes. These factors are chance; shrewd management of the families' position, especially via advantageous arranged marriages; differences in the usefulness of families to their feudal superiors; and different entrepreneurial ability in successive generations of the family. He argues for a sort of automatism—a family that simply reinvests a proportion of its profits in its business is bound to go under sooner or later. Bad luck strikes, competition emerges, politics shift, and, most important, entrepreneurs die. Schumpeter (1951, p. 122) stresses that rare entrepreneurial ability is the foundation of most great family fortunes but is an individual trait and does "not coincide with the logical necessity that obtains in the case of family enterprises." This, he continues, means "the complete displacement of powerful family positions as typical phenomenon, not merely the shifting of positions between families." The entry and exit of families is thus "individually effected" (p. 123), so that classes survive, but families come and go. He concludes (p. 130) that "the persistence of class position is an illusion, created by the slowness of change and the stability of class character as such and of its social fluid."

Ultimately, Schumpeter's (1912) notion of creative destruction is an underlying principle of capitalism. But innovation and entrepreneurship need to be nurtured. Oligarchic family elites can use their considerable wealth and connections to maintain their power and control at the expense of economic development. Haber (1999), Morck, Wolfenzon, and Yeung (2004), Olson (1963, 1982), Rajan and Zingales (2003), Thurow (1989), and others call such entrenched elites *oligarchies.* Thurow, for example, distinguishes *establishments* from *oligarchies.* Both are well-educated, wealthy, powerful, intermarried elites who

> run their countries. . . . [But] the central goal of an establishment is to insure that the system works so that the country will in the long run be successful. An establishment is self-confident that if the system works and if their country does well, they will personally do well. . . . In contrast an oligarchy is a group of insecure individuals who amass funds in secret Swiss bank accounts. Because they think that they must always look out for their own immediate self-interest, they aren't interested in taking time and effort to improve their country's long-run prospects. (p. 405)

The studies in this volume provide ample evidence of powerful family business groups behaving as establishments, oligarchies, or first one and then the other.

Business Groups

Conceptualizing economic activity in terms of business groups, as opposed to freestanding firms, is an incompletely understood area—perhaps because groups are rarest in the United States and United Kingdom, where business research is most active. A literature on business groups is coalescing but is probably decades behind that for other issues of similar importance.[9] The literature is probably most developed in connection with Japan, where area studies scholars have long appreciated business groups' importance.[10] However, Japanese business groups, as Morck and Nakamura show in chapter 7, have a history starkly different from groups elsewhere. Most important, large horizontal Japanese *keiretsu* are controlled by managers, not wealthy families.

9. See Bae, Kang, and Kim (2002), Bebchuk, Kraakman, and Triantis (2000), Barca and Becht (2001), Bertrand, Mehta, and Mullainathan (2002), Claessens, Djankov, and Lang (2000), Claessens et al. (2002), Daniels, Morck, and Stangeland (1995), Faccio and Lang (2003), Faccio, Lang, and Young (2001), Faccio (2002), Ghemawat and Khanna (1998, 2000), Granovetter (in press), Khanna and Palepu (2000), Morck et al. (2000, 2004b), and others.

10. See, e.g., Aoki (1988), Hoshi, Kashyap, and Scharfstein (1991), and especially Nakatani (1984).

Humans' tendency to organize activities along patterns of kinship may be biologically innate, as Axelrod and Hamilton (1981) suggest. But this organizing propensity continues long after the biological necessity is removed, and often extends to economic activity. Family and kinship groupings are likely the oldest and most pervasive forms of group behavior. From an economic perspective, Khanna and Palepu (2000) conceptualize family business groups "as a mechanism through which intragroup transaction costs are lowered, by encouraging information dissemination among group firms, reducing the possibility of contractual disputes, and providing a low-cost mechanism for dispute resolution" (p. 271).

Economic welfare, in theory, is greatly enhanced if trade extends beyond kinship groups and even encompasses anonymous transactions. Firms that raise capital from public shareholders at low cost can expand more rapidly than those constrained by family wealth. Family-controlled pyramidal groups arose everywhere as devices to tap public equity financing on a huge scale but retain family control over all key decisions.

Groups that do not fit this pattern, such as modern Japanese *keiretsu,* German bank groups, and groups with widely held or state-owned enterprises at their apexes, are exceptions, but important ones. In every case, they too are structured to preserve public equity financing while locking in control by insiders—professional managers, bankers, or bureaucrats, rather than wealthy families. The broader theme of concentrated control seems to encompass all business groups everywhere.

Why might such concentrated control develop and persist? Why does it most often rest with a handful of wealthy families? At this point we can only speculate.

There is safety in numbers, and as Aristotle wrote in his *Ethics,* "Men journey together with a view to particular advantage." Sociologists have long recognized that "involvement and participation in groups can have positive consequences for the individual and the community" (Portes, 1998, p. 2). Granovetter (in press) speculates that American-style freestanding widely held firms did not last in postwar Japan because the "planners had dramatically underestimated the extent to which the dense web of ties connecting firms within these groups, and the resulting sense of group identity and patterns of customary cooperation, could persist and regenerate even without direction from family owners." Perhaps, but group identity and cooperation need not require intercorporate equity holdings, which Morck and Nakamura's chapter argues were established as takeover defenses in the 1950s and 1960s. In their view, Japanese groups were raised from the dead to protect the positions of top corporate managers.

Khanna and Palepu (1997, p. 41) note that the "diversified business group remains the dominant form of enterprise throughout most emerging markets." They caution economic planners and executives in those countries against imitating Western-style freestanding industrially focused firms. They argue that ties of the sort Granovetter (in press) proposes substitute for markets and institutions that permit anonymous or arm's-length transactions in developed countries. Khanna and Palepu (p. 41) argue that if "a country's product, capital, and labor markets; its regulatory system; and its mechanisms for enforcing contracts" are not trusted, business groups substitute for them. Trust between family members running various group firms substitutes for trust in business contracts, financial markets, or labor market signals.

Trust

Cooperative behavior with blood kin may well be genetically programmed, making families the default junctures of high-trust behavior for the individuals within them. But wider networks of high-trust behavior appear to be important to the creation of an effective system of governance for large organizations and of reliable institutions in general.[11] Mayer, Davis, and Schoorman (1995, p. 712) define trust as "the willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party." Arrow (1974, p. 23) explains the advantages it bestows thus: "Trust is an important lubricant of a social system. It is extremely efficient; it saves people a lot of trouble to have a fair degree of reliance on other people's word." Trust can lower transaction costs and permit effective coordination and control. Macaulay (1963, p. 55) makes a strong case that the governance of business transactions has an important dimension that goes beyond formal agreements and contracts. He argues (p. 58) that formal legal contracts cover a very small portion of all business conducted, and that business people largely prefer to rely on mechanisms such as "a man's word," a "handshake," or "common honesty and decency."

For Fukuyama (1995) a high level of societal trust improves the performance for all the society's institutions. The absence of trust—or, more seriously, distrust—makes coordination and control problematic. In certain situations, such as the grafting of Western capitalism onto a developing economy with low general levels of trust for nonkin, a "mismatch" of trust occurs where people take advantage of the erroneous expectations of others. This is a key theme in the chapter by Goetzmann and Köll, in which Western institutions built on certain assumptions of trust failed abjectly in prerevolutionary China when adjoined to its ancient entrenched bureaucracy.

Although readily destroyed, trust in a society's institutions is not easily

11. Regarding trust in large organizations, see Bradach and Eccles (1989), Coase (1937), La Porta et al. (1997b), Powell (1990), Sahlman (1990), Steier (1998), Stinchcombe (1965), and Williamson (1975, 1985). Regarding institutions broadly interpreted, see Coleman (1988), Putman (1993), and Fukuyama (1995).

built up. Putnam (1993) describes how economically important networks of trust in Northern Italy were built through centuries of successful association. The chapter on Canada by Morck et al. describes that country's evolution from a low-trust society in which families were virtually the only instruments of trust reliable enough to finance business ventures. Murphy's chapter on France describes the destruction of popular trust in the institutions of arm's-length finance.

Certain organizational arrangements can substitute to some extent for low trust outside families and can even increase ambient levels of trust, albeit slowly. Khanna and Palepu's chapter on India describes the importance of ethnic minorities in India's early large businesses. The relatively small size of these communities in large markets permitted both relationships of trust between key decision makers and certain economies of scale. In India and other countries, small elites developed within which huge deals could be consummated largely on the basis of trust.

This view of business groups is underscored by the business histories of many of the countries surveyed in this volume. The earliest origins of Japan's family business groups, or *zaibatsu,* were to circumvent low-trust problems. For example, the Mitsui family expanded into commodity trading because their silk business depended on barter deals. They later moved into banking to move Japan beyond barter deals into a real financial system.

It also helps explain the structures of business groups. The relational approach to strategy and economics propounded by Dyer and Singh (1998), Landes (1998), and Portes (1998) suggests that economic success depends on effective network relationships. Burt (1992b, p. 11) thus argues that "something about the structure of the player's network and the location of a player's contacts in the social structure of the arena provides a competitive advantage." In this light, business groups should be structured around critical transactions where trust is important. Effective networks contain enough members to accomplish the task, but not so many as to be unmanageable nor unnecessary or redundant.

Burt (1992a) models effective network ties as links to clusters of resources. The number of ties matters less than the clusters of resources accessed. A bigger network is only more effective if it connects to additional pertinent clusters of resources. An effective network thus contains "structural holes," where the costs of expansion outweigh the benefits (Burt 1992a, p. 65). There are advantages (Burt 1997, p. 343) to "having a contact network rich in structural holes." Business groups should grow to encompass relevant clusters but avoid redundant relationships by economizing on ties. Thus, very early Canadian groups began with timber businesses and expanded into ship building, then shipping, and then insurance.

Business-government relations are also critical links for business groups in many countries. Högfeldt's chapter on Sweden essentially argues that

Socialist politicians viewed family-controlled business groups as effective links to the whole of the private sector. By abetting dynastic family control over wide circles of firms, these politicians established a system where they could negotiate with the greater part of the large corporate sector over a small table. He adds that this may have stymied the development of arm's-length institutions in Sweden. This logic of business groups as second-best solutions impeding movement toward first-best solutions is echoed in several other chapters.

Franks et al. (chap. 10) argue that fear of losing one's reputation spread trustworthy behavior widely across British corporate governance by the early twentieth century. But in the rest of this volume, legal or regulatory sanction as reprisal for unacceptable grasping seems necessary to elevate ambient levels of trust, though exactly which sanctions mattered historically in which countries remains unclear.[12] In the United States especially, Becht and DeLong (chap. 11) see popular disquiet with concentrated economic power as perhaps more important than economic inefficiency in advancing tax, securities law, and other regulations that ultimately destabilized large business groups.[13] And Sylla and Smith (1995) argue that law played a greater role in Britain than Franks et al. allow.

Law

In a fundamental paper, La Porta et al. (1997a) argue that stock market development should be positively correlated with shareholder legal protection. Shleifer and Wolfenzon (2002) formalize this argument with a model in which controlling shareholders sell out to diversify if their rights as portfolio investors are legally protected. Otherwise, they remain undiversified blockholders in the companies they manage and consume what private benefits they can extract from their public shareholders. La Porta et al. (1997a) measure shareholder rights by focusing on six specific legal rights shareholders have in the United States and counting how many of them shareholders have in other countries.[14] They find that in the 1990s countries with stronger shareholder protection were characterized by larger stock markets and more diffusely held large corporations, and that these countries tend to have legal systems derived from British common law. The common-law countries in figure 1 are Australia, Canada, Hong Kong, Ireland, New Zealand, Singapore, the United Kingdom, and the United States, and they clearly do have more widely held large firms than

12. See La Porta, López-de-Silanes, and Shleifer (2003).

13. See Morck (2004b) for detail on these regulatory attacks.

14. This index adds one point if the country lets shareholders mail in proxy votes, does not require shares to be deposited prior to a general shareholders' meeting, allows cumulative voting or proportional representation of minorities in the board, provides an oppressed minority remedy, lets an owner of 10 percent or less of the share capital call an extraordinary shareholders' meeting, or lets shareholders' preemptive rights be voided only by a shareholders' vote.

the other countries, all of which employ civil codes of one form or another. La Porta et al. (1997a, 1999) conclude that diffuse ownership and shareholder capitalism require solid legal protection of public shareholders' property rights in their investments.

Several of the chapters in this volume beg to differ. Murphy remarks in chapter 3 that "in a post Enron, Tyco, WorldCom world, French jurists and financiers might be permitted a wry smile at the implication that the common-law system is linked to a strong system of corporate control." Fohlin argues that her chapter "casts doubt on the notion that civil law traditions per se consistently undermine market functioning" because German stock markets ebbed and rose at various points, while its legal system changed little. She also fails to find any temporal correlation between changes in shareholder protection and ownership diffusion. Franks, Mayer, and Rossi argue that British shareholders had none of the legal rights La Porta et al. (1997a) enumerate until 1948, and only attained their current level of protection in the final third of the twentieth century.[15] Yet they find that the ownership of new British firms dispersed as quickly early in the twentieth century and in its latter decades. Canadian shareholders had few of these same rights until the 1960s, but Morck, Percy, Tian, and Yeung find that Canadian corporate ownership grew widely dispersed by the middle of the twentieth century and that family-controlled pyramidal groups staged a roaring comeback at the century's end and under unprecedentedly strong shareholder rights laws. France, Germany, Italy, Japan, the Netherlands, and Sweden all had economically very important stock markets off and on through their history—especially at the beginning of the twentieth century, as noted by Rajan and Zingales (2003). Becht and DeLong argue in chapter 11 that U.S. shareholders remain vulnerable to many forms of expropriation by corporate insiders despite their statutory legal rights, and Aganin and Volpin (chap. 6) argue that shareholder rights in Italy are a dead letter because of general judicial system inefficiency.

Three general criticisms of La Porta et al. (1997a, 1999) emerge. First, the timing of improved shareholder rights does not match the timing of ownership dispersion in several countries. Second, the correlation between large stock markets and shareholder rights is highly specific to the late twentieth century. Third, the La Porta et al. shareholder rights index is an incomplete proxy for actual shareholder legal protection. The thesis that statutory shareholder rights cause stock market development and ownership diffusion is hard to square with these findings. However, the thesis that a country's legal system, or some other factor highly correlated with this, *predisposes* it to a certain form of capitalism, which is really the funda-

15. Cheffins (2001) also argues that British legal developments weaken the thesis of La Porta et al. (1997a, 1998), though Sylla and Smith (1995) argue that late nineteenth-century developments in British law actually did strengthen shareholder rights considerably.

mental point La Porta et al. advance, is harder to challenge. Indeed, the chapters of this book provide fairly solid evidence in its favor.

Murphy (chap. 3) does not argue that the French legal code is unimportant but rather that French public investors grew skeptical of stock markets because of repeated financial crises. Yet the response of French politicians and jurists to each crisis was not to strengthen investor rights. Rather, the response to the Mississippi Company bubble was to reassert Roman Catholic prohibitions on interest and to all but shut down the financial system. Neither the revolutionary government's *assignats* nor the Crédit Mobilier fiasco heralded stronger investor rights. Likewise, the responses of the Dutch, Italian, Japanese, and Swedish governments to the financial crises of the 1920s and 1930s were to substitute various mechanisms of state-controlled capital allocation for their stock markets. In contrast, a not dissimilar succession of financial manias, panics, and crises in Britain, Canada, and the United States ultimately strengthened shareholder rights. Clearly something in their legal systems changed. Why did financial crises trigger fuller disclosure, better regulation, and stronger investor rights in common-law countries but a disconnection of the stock market from the economy in countries with civil law traditions?

Aganin and Volpin (chap. 6) shed light on what happened in Italy. After the crash of 1907, Fiat's shareholders sued the Agnelli family for accounting irregularities and stock price manipulation. The Agnellis were cleared of all wrongdoing, but investor confidence in the stock market was deeply shaken, and Italy remained in a prolonged financial crisis through 1914. Aganin and Volpin argue that "there was a general market perception that universal banks and corporate insiders like the Agnellis used the investment boom early in the century to pump and dump their shares."

Morck and Nakamura (chap. 7) describe how the American occupation force redesigned the ownership structures of Japan's major corporations in the late 1940s to make them widely held. Yet Japanese managers, fearful of hostile takeovers, placed blocks of stock with each other's firms to defend against raiders, forming the current *keiretsu* groups. Recent work in the United States and other countries shows that barriers to takeovers are not in the best interests of shareholders. Yet the Japanese managers acted anyway, for Japanese shareholders had no legal right to object.

One interpretation of the findings in this volume is that both civil law and common-law countries create large financial markets but that common-law countries are better able to *sustain* them over the longer run. Perhaps, from time to time, a new generation in a civil law country discards the advice of its grandparents and invests heavily in stocks. Once it becomes clear that its rights are ill protected, the values of its portfolios collapse and the next generation or two shun the market again until collective memory fades and a new generation of marks is born.

But what is it about common-law systems that sustains large stock markets and makes sustained diffuse ownership possible? If La Porta et al.'s (1997a) shareholder rights are recent statutory innovations in most common-law countries, why are investors in those countries generally more accepting of stocks? One possibility is deeper characteristics distinguishing common law from civil law.

One such difference emerged in the early seventeenth century, when France was exhausted by its Wars of Religion (1562–98) and England was devastated by its Civil War (1625–49). Cardinal Richelieu sought to reunite France by centralizing power in the hands of an absolute monarchy. Bloodied by years of chaos, the French people accepted this as a sort of salvation. The arbitrary Revolutionary Tribunals of the late eighteenth century left the public mistrustful of judicial discretion and probably made the French people, and Napoleon in particular, receptive to the rigid codification of the law and the subjugation of judges to the executive branch of government. Thus, Napoleon replaced France's prerevolutionary civil code with a new, expanded Napoleonic Code, and his armies exported this across the European continent. Meanwhile, England had developed a tradition of an independent judiciary—the Courts of Common Law—as alternatives to the royal courts—the Exchequer and the Court of Star Chamber. This was a reflection of a broader struggle for power between the monarch and Parliament that came to a head with Cromwell's Commonwealth (1649–60). Parliament won both the English Civil War and the battle for the courts that followed. English courts became independent of the executive branch and subject only to Parliament.[16]

This gave English and French jurisprudence very different flavors.[17] To vastly oversimplify, the French courts existed to implement the will of the king, while the English courts existed to protect free Englishmen from abuse by their king. Over time, *government* came to be substituted for *king,* but the difference persists. Common-law systems protect the weak from the strong; civil law systems enforce the edict of the state. This distinction disposes courts in common-law countries to protect public shareholders, even in the absence of explicit statutes.

A second underlying difference is that civil codes provide detailed instructions to judges that try to anticipate all possible cases and specify decisions for each. The judge looks to the letter of the law anew in each case. Merryman (1966, p. 586) describes the resulting dominance of doctrine and how judicial decisions read "more like excerpts from treatises or commentaries on the codes than the reasoning of a court in deciding a concrete case." Under common law, judges base rulings upon general principles and previous cases as well as legislation. This, with the relative independence of the judiciary from political interference, renders *all* common-law courts, to

16. See also Hayek (1960) and Glaeser and Shleifer (2002).
17. See Watson (1981), Pistor et al. (1999), Glaeser and Shleifer (2002), and others.

some extent, activist courts. Decisions are less responsive to the minutia of a legal code and more to the perceived viewpoint of a *reasonable man,* a *prudent man,* or the like. Corporate insiders who pilfer from public shareholders in a common-law jurisdiction, even if they fastidiously avoid breaching all written statutes, can never be entirely certain the courts will not find a precedent or general principle to convict them anyway. This uncertainty might contribute to better general treatment of public investors in common-law countries, even before those countries enacted the specific statutory rights La Porta et al. (1997a) enumerate.

A third difference, which flows from the first two, is the quality of judicial decisions. Both common-law and civil code systems can be of high quality, but both also have weak points.[18] Three particular vulnerabilities to which civil law systems are prone are of special concern in cases of corporate governance that pit connected corporate insiders against impecunious public shareholders. First, because civil law judges are bureaucrats subordinate to the government, ill-functioning courts are malleable to political pressure.[19] Second, because decisions depend on complicated codes rather than broad principles, a poorly functioning civil law system can favor litigants who are better at parsing those codes. Third, because precedent is less a guiding principle, civil law judges can shrug off how their judgments affect people's future behavior in the belief that good bureaucrats should defer to politicians.

These differences can all be overstated, of course. The United States has codified its contract law in the Uniform Commercial Code, and its securities laws in the Securities and Exchanges Act and various and sundry legislation. These codes are easily as detailed as many civil codes.[20] Meanwhile, Enriques (2002) documents how civil codes contain "general clauses" instructing judges to apply certain standards on a case-by-case basis, and civil law judges sometimes even create new standards or extend existing ones. Although these clauses theoretically allow civil law judges latitude to convict wrongdoers who delicately avoid breaking the letter of the law, they seldom exercise it—perhaps because of their doctrinal training. Finally, the executive branch of government appoints high court judges in most common-law countries, and some might see this as subjugating the courts. There is even disagreement among legal scholars about the degree of protection civil law countries actually accord public shareholders. For example, Ramseyer and Nakazato (1999) argue that Japanese law gives public shareholders fairly strong legal rights. Many legal scholars

18. Berkowitz and Clay (2004) find that U.S. states with civil law colonial legal systems (Florida, Louisiana, and southwestern states taken from Mexico) have more constitutional instability than purely common-law states. Whether this reflects inherent problems in civil law or in switching legal systems is not fully clear, though they favor the latter explanation.

19. See Hayek (1960), Mahoney (2001), and La Porta et al. (2004).

20. See Weiss (2000).

thus regard the distinction between civil and common law as primarily of historical interest.[21]

Nonetheless, these three differences might perhaps coalesce into an explanation.[22] Many common-law and civil code countries had large stock markets to which numerous small investors entrusted their savings at various points in their histories. All of these countries experienced financial panics and crises, but these seem to have devastated shareholder cultures in civil law countries worse than in common-law countries.

Albeit often with very long lags, financial crises induced stronger shareholder legal rights in common-law countries. Coffee (2001) argues that common law created a better environment for self-regulation. Moreover, a succession of British court decisions and laws, beginning with the Joint Stock Companies Registration, Incorporation, and Regulation Act of 1844, steadily expanded investor legal protection. Indeed, the committee that drafted the 1844 act reflected long on past financial crises and stock market bubbles and "classified bubble companies into those naturally unsound, those unsound through bad management, and those clearly fraudulent. For the first nothing could be done, and for the others the great remedy was publicity" (Frentrop 2003, p. 155). In contrast, civil law countries typically responded to such crises by using banks or state investment programs to circumvent the stock market. Thus, Aganin and Volpin (chap. 6) write that "in Italy, the government responded to the Great Depression by becoming a substitute for capital markets. Post war [*sic*] governments saw no great need to improve capital market regulation." Most other continental European countries and Japan adopted similar policies. This reflects the first intrinsic difference between the two systems. Common-law countries' courts and governments sought to protect the weak from the strong; civil law countries' governments sought alternative ways of implementing the public-policy goal of efficient capital allocation. Their courts, ill equipped to restore faith in capital markets for the reasons outlined above, let matters rest.

Franks, Mayer, and Rossi (chap. 10) write of higher standards of ethics in British than in foreign businesses. This might reflect the second intrinsic difference between common-law and civil code systems, the uncertainty intrinsic to common law. Precedent and general principle can convict wrongdoers who rely overly on the letter of the law. Certainly, Becht and DeLong (chap. 11) ascribe the diffusion of ownership to shareholder rights created by activist common-law courts in the United States. Perhaps small investors in common-law countries factored in the probability of some property rights protection despite an absence of statutory rights, and this sus-

21. See, e.g., Markesinis (2000), and see also Posner (1996).
22. See also Weiss (2000) for the argument that differences, though perhaps overstated by some scholars, exist and are important.

tained their stock markets through rough patches. Sylla and Smith (1995) argue that legal reforms in late nineteenth-century Britain could have permitted this.

Enriques (2002) tracks Italian corporate judicial rulings through the late 1980s and 1990s and finds a bias in favor of corporate insiders and highly formalistic arguments; but no evidence that judges consider the impact of their rulings on the incentives or behavior of firms and managers. Aganin and Volpin (chap. 6) refer to these findings, and to evidence in La Porta et al. (1998) of the low quality of legal enforcement in Italy, to stress that weak Italian corporate governance might reflect a poor-quality judicial system rather than an absence of specific shareholder rights or a civil law system per se. But the third intrinsic difference between common law and civil codes points to judicial dysfunction in these specific areas of law, which matter critically to the corporate governance of diffusely owned firms, as special vulnerabilities of an ill-functioning civil code system.

Overall, the studies in this volume do not undermine the basic argument that differences in legal systems matter. Indeed, de Jong and Röell (chap. 8) present the only discussion of a discrete change in legal system, describing how Napoleon's imposition of his civil code on the Netherlands undid much of its financial development.[23] Frentrop (2003) confirms much of this in more detail. De Jong and Röell clarify the subsidiary importance of lists of statutory shareholder rights and underscore the need to study more fundamental differences between legal systems. Effective shareholder legal protection takes more than a complete checklist of statutory provisions. La Porta et al. (2004) and La Porta, López-de-Silanes, and Shleifer (2005) stress more fundamental legal system differences turning on judicial independence, disclosure, and securities laws.

Origins

Much recent work posits that the institutional differences between modern countries derive, in part at least, from differences in their preindustrial economies.[24] To some extent, these arguments are motivated by econometric considerations. A truly exogenous variable is needed to resolve many of the econometric issues that bedevil empirical economics, and where better to find one than in the distant past? But beneath these technical motivations there lies a genuine belief that past centuries' events and conditions constrain today's decision makers and institution builders.

An extreme thesis of this sort is that economic development is predestined by geography. This is an uncomfortable philosophy to economists, for it diminishes somewhat their trade. Yet Diamond (1997) posits precisely

23. Though Mokyr (2000) argues that Dutch laws and institutions needed serious reform at this point anyway because heirs to its earlier economic success had become entrenched and blocked further progress.

24. La Porta et al. (1997a) justify the exogeneity of legal origin on this basis.

this.[25] Others, like Weber (1904) and Stulz and Williamson (2003), argue, in a parallel vein, that deeply ingrained cultural factors predetermine economic prosperity. Weber stresses the unique developments surrounding the Protestant Reformation in Europe and argues that these prepared Europe uniquely for free markets and rapid economic growth. True, the first two economic powerhouses of modern Europe, Britain and the Netherlands, were resolutely Protestant, as were many principalities that became Germany. The religious wars that swept Europe funneled educated refugees and capital into the uniquely tolerant Netherlands as Dutch merchants invented the joint-stock company. The English Civil War, which freed British courts of royal oversight, certainly had a religious side—unfinished business from the Reformation. But German industrial development occurred long after the Reformation, and not much before similar bursts of growth in Catholic Europe in the twentieth century. Högfeldt's chapter on Sweden describes decidedly oligarchic institutions given a modern social democratic sheen. And other Protestant countries, like the Baltic states, remained outside the modern world until quite recently.

An alternate approach to predestination, more conducive to economic analysis, is Haber's (1999) argument that different countries have different economic institutions—customs, cultures, and traditions as well as legal systems—and that these institutions determine how people behave, and hence what sorts of public and private investments are feasible.[26] Sound institutions protect private property rights, encourage the honest payment of taxes, and enforce contractual agreements and other forms of cooperation. In a sound institutional environment, large-scale public and private investment are made possible by freedom from the threats of theft, cheating, and reneging. With varying qualifications, this situation characterizes today's developed economies. In particular, sound institutions of corporate governance permit the existence of large corporations and their ownership by diffuse investors.

But an absence of sound institutions leads to different arrangements. Where the state and investors cannot rely on arm's-length arrangements to protect property rights, one must co-opt the other. To protect their property rights, powerful individuals and families in such countries control the police powers of the state. Or those who control the state appropriate what wealth the economy has, invest it to benefit themselves, and use their po-

25. Diamond (1997) argues that the larger land mass of the Eurasia gave rise to more domesticable plants and animals and that its primarily east-to-west orientation permitted their rapid diffusion. This gave its inhabitants a permanent lead in the process of economic development. Our problem with this thesis is that most domesticated plants and animals derive from wild species. Ex post, the ancestors of wheat and cows must have been domesticable. This does not mean New World species, like turkeys and potatoes, could not have been domesticated earlier and more fully too. Who knows how good a beast of burden might have been bred from, say, the plains bison?

26. This work builds upon Olson (1963, 1982) and others.

lice power to protect their investments. Either solution frees investors from the danger of losing to cheaters, thieves, and scoundrels. However, unsurprisingly, these oligarchs see little reason to protect the property rights of others. This leads to *oligarchic institutions*—the governance of most economic activity is entrusted to wealthy oligarchs who use the state to protect their interests, and most of the population lives without meaningful property rights or extensive public goods. Haber (1999) views Latin America as typifying this form of economic organization.

Once oligarchic institutions are in place, oligarchs understandably prefer the status quo and use the state to prevent institutions from changing. Olson (1963), Acemoglu and Robinson (2000), Acemoglu, Johnson, and Robinson (2001, 2002a,b), and Morck, Wolfenzon, and Yeung (2004) all present mechanisms through which this can happen and which give rise to a sort of economic predestination. Once a country has oligarchic institutions, upending them is not easy.

Advanced non-Western economies, according to Acemoglu, Johnson, and Robinson (2002b), had well-developed indigenous institutions that evolved to exploit natural resources for the benefit of the local elite. European colonial rulers and postcolonial independence leaders retained these oligarchic institutions, hampering broad-based economic development. Consequently, the most advanced non-Western societies—Asia, the Islamic world, Mexico, and Peru—have the most problems incorporating modern Western institutions.

This certainly resonates with the chapter on China by Goetzmann and Köll, which describes how the traditional Chinese imperial bureaucracy, acting as it always had, undermined well-intentioned and carefully written legal reforms aimed at establishing the institutions of good corporate governance in late nineteenth-century China. In contrast, Japan, a much younger civilization, whose local institutions were in disrepute at the time of its opening to the West, managed a more successful transplant of Western institutional arrangements.

The chapter on India fits less fully with the thesis of Acemoglu, Johnson, and Robinson (2002a). Khanna and Palepu point to India's ancient precolonial mercantile traditions, carried into the modern world by specific ethnic minorities—especially the Marwari, Gujerati, and Parsi. They document the close ties between India's leading mercantile families and both the British Raj and Congress party, and describe situations similar to Haber's (1999) depiction of Latin American oligarchic institutions and in line with Acemoglu, Johnson, and Robinson. However, Khanna and Palepu go on to describe how the Tata family, which was politically close to the British colonial government, lost much of its political influence after independence, and especially after India embraced Nehruvian Socialism. The family's response was an energetic entrepreneurial strategy that worked around a mainly hostile License Raj and built up sufficient capital and goodwill to finance a large part of India's new software industry.

Acemoglu, Johnson, and Robinson (2001) argue that patterns of European settlement centuries ago determine modern economic institutions and patterns of corporate control in the modern world. They argue that where European settlers could survive, they created institutions that promoted economic development, but that where they could not survive, they created institutions that facilitated the fastest possible extraction of valuable resources. Those oligarchic institutions, once established, were locked in, condemning the latter countries to centuries of poverty and exploitation by colonial and then local elites.

The chapters on Canada, India, and the United States—all former colonies—speak to this thesis. Those on Canada and the United States document early institutions and institutional development not very different from those of their colonial masters, the British and French. Morck et al. (chap. 1) make the point that Canada's longer presettlement history as a French, and then British, fur trade entrepôt gives it some institutional echoes of a colony of resource extraction run in the interests of a tiny elite. Clearly, colonial and traditional institutions do persist, and constrain subsequent institutional development.

Evolution

But this argument can be pressed too far. European countries also have their colonial origins. France was a Roman colony, and the French civil code is essentially a revised version of the code Justinian applied to all parts of the Roman Empire, including Gaul. The Romans adopted Greek ideas, and the Greeks drew from Egypt. Modern European institutions of government, society, and law still echo ancient antecedents, but they have also clearly evolved.

Institutions change—occasionally radically—dooming predestination as a complete explanation of modern institutions. Olson (1982) argues that major institutional changes require major disruptions, like wars or disasters, which weaken the elite sufficiently to interrupt its control of the state. This certainly resonates with several of the chapters in this volume and other work on the history of corporate governance. Frentrop (2003) argues that the Dutch developed the first joint-stock company, the Dutch East Indies Company, founded in 1602, to gain leverage against larger European powers that threatened them.[27] This company pioneered the use of share certificates traded on a stock exchange to raise money. This freed the company from financial dependence on a royal exchequer so that economic logic, rather than court intrigue, might determine strategies. Its commercial success catapulted the small Dutch Republic from obscurity to chal-

27. See Frentrop (2003) for details.

lenging the Spanish Empire, built on New World gold, and the Portuguese domination of the circum-African spice trade. In the seventeenth century, the British imported successful Dutch institutions along with the House of Orange after the Glorious Revolution. In the nineteenth century, the French, Germans, Italians, and Swedes—and even the Dutch—could all look to Britain for model institutions when their own came into disrepute. In the twentieth century, Germany, the Soviet Union, Japan, and the United States each took Britain's place in different decades, with decidedly more mixed results.

The chapters in this book show that institutional change seems to require a crisis in existing institutions and a workable role model for new ones. The Tokugawa shoguns lost face irreparably by capitulating to Admiral Perry and opening Japan to American trade. This loss let the Meiji leaders stage a coup and undertake wholesale changes to every aspect of Japanese society. The American Revolution and the liberal rebellions in 1830s Canada also clearly reshaped institutions. But the financial chaos of the French Revolution, according to Murphy (chap. 3), helped induce institutions that delayed French financial development. Good intentions are certainly no guarantee of good results.

Most important to recent developments in corporate governance, the Great Depression emerges in virtually every chapter as a key formative experience. In the United States, this crisis activated progressive political forces that broke up America's great pyramidal groups. But in Canada, it triggered a return to old mercantilist traditions, as the government cartelized the economy to fight deflation. In Sweden, the Great Depression left scores of firms bankrupt and the Wallenbergs' bank holding control blocks of their shares in lieu of debt repayments. In Germany, Italy, and Japan, the Depression brought in extremist political movements, which subordinated corporate governance to ideology.

Transplants

The histories recounted in this volume contain several instances of one country deliberately adopting institutions developed in another. Generalizations from these few histories must be highly tentative. Nonetheless, a few patterns stand out.

Transplants between Western countries seem healthier than those from Western to non-Western countries. This might be because none of these institutions was totally foreign to the importing country. Thus, the Napoleonic code was successfully transplanted to the rest of continental Europe, including the Netherlands. That most of Europe already used variants of Roman civil law prepared the ground. Sweden adopted first Scottish and then German banking with little difficulty, but Swedes were already quite familiar with each system beforehand. Canada borrowed much of her securities laws from the United States, but many Canadians were already familiar with American securities laws from doing business in the United States.

Transplants to non-Western countries seem less robust. The chapter on China describes a rejected transplant. In the late Qing dynasty, China's entrenched bureaucrats could not comprehend the concept of independent firms, as envisioned in its Westernized corporations law. The bureaucrats' traditional concepts of patronage and loyalty congealed into endemic corruption that replaced Chinese capitalism with Soviet institutions. The chapter on India describes how shoddy Soviet transplants also corroded India's British institutions after independence, though less completely. The Japan chapter describes that country's serial adoption of a sequence of foreign institutions.

All of these observations concur well with the *transplant effect* proposed by Berkowitz, Pistor, and Richard (2003) and Pistor et al. (2003, p. 81), who argue that legal evolution is continuous and gradual in countries with indigenously developed legal systems but that transplanted legal systems stagnate for long periods, with interruptions of radical and even erratic change. Pistor argues that transplanted legal systems that can adapt are more likely to succeed. Without disputing this, Goetzmann and Köll (chap. 2) propose that indigenous Chinese institutions undermined promising transplants. This raises the possibility that operational home-grown institutions might marginalize or capture transplants, rendering them dysfunctional.

Large Outside Shareholders

Corporate governance is an important determinant of the distribution of economic power, and thus a key plank of reform in many political ideologies.

For example, the French Revolution probably injected an important ideological element into European corporate governance. Dunlavy (2004) argues that many corporate shareholder meetings were radically more democratic in the early nineteenth century than they are now. Many corporate charters at that time granted *one vote per shareholder,* rather than *one vote per share,* which Dunlavy calls *plutocratic voting.* Others had scaled voting rights systems, which granted larger shareholders fewer votes per share or capped their voting rights. The one-vote-per-shareholder system may have reflected common legal rules governing business and municipal corporations. However, such voting systems were by no means universal in the early history of capitalism. For example, the 1670 charter of the Hudson's Bay Company provided for one vote per share, not one vote per shareholder. Dunlavy reports that plutocratic voting rapidly came to dominate American shareholder meetings but that more democratic shareholder meetings persisted through much of the nineteenth century on the European continent.

Perhaps the radical democratic ideals of the French Revolution sustained the popularity of one-vote-per-shareholder corporate governance on the continent. Certainly, Frentrop (2003) argues that "the ideal of equality promulgated by the French Revolution made the shareholders' meeting, which provided equal rights for all shareholders, the most powerful body of the company. This was so self-evident that Napoleon's 1807 Code de Commerce does not mention it. Directors were dismissible agents of the shareholders."

An alternative explanation, proposed by de Jong and Röell (chap. 8) in connection with the Netherlands, is that corporate insiders limited the voting power of large outside shareholders to entrench themselves. Certainly, both explanations could be true. Corporate insiders might have cynically exploited popular ideologies to lock in their control rights. Or they might have genuinely subscribed to ideologies that coincidentally entrenched their economic power.

Rajan and Zingales (2003) advance the former thesis to explain why the financial systems of many countries atrophied during the twentieth century. They show that many countries had much larger and more developed financial systems at the beginning of the century than at the end of the cold war era. They propose that a first generation of entrepreneurs raised money to finance industrialization at the beginning of the century and that they or their heirs lobbied for government policies that crippled their countries' financial systems to prevent competitors from raising capital. One way to do this is to support high income taxes and low estate taxes. Another might be checks on the voting power of large outside shareholders, which might have been an ideologically acceptable way to do this.

Shleifer and Vishny (1986, 1997) argue that large outside shareholders, by rendering takeovers credible threats, cause corporate managers in the United States to work harder, and that this raises share prices for small investors. Weakening large outside shareholders would entrench existing insiders by stopping takeovers and would make stocks less attractive to small investors, depriving potential entrants of capital.

However, large outside shareholders may have interests of their own that mesh poorly with small shareholders' interests. Corporate pension funds might be reined in by corporate management to invite reciprocal treatment from their counterparts' pension funds. Public-sector pension funds might be subject to political influence. Nonetheless, Franks, Mayer, and Rossi (chap. 10) argue that institutional investors were clearly a force for good governance in the United Kingdom. Perhaps they are set to play similar roles elsewhere too.

Becht, Bolton, and Röell (2002) stress finding a balance between managerial discretion and small shareholder protection. Systems that lean too far toward protecting small shareholders from blockholders let existing corporate insiders do as they like because small shareholders lack the resources to challenge them. Leaving too much power in the hands of large blockholders exposes shareholders to expropriation and perhaps also subjects managers to unwarranted monitoring.

Financial Development

In a historical study of German universal banks, Kleeberg (1987, p. 112) remarks that "the best advice for a young German industrialist who needed more capital was to marry a rich wife . . . this was the advice which the cologne merchant Friedrich Sölling constantly pressed upon his partner Adolf Krupp. Hence the extremely complicated family trees and numerous intermarriages among the Rhenish Bourgeoisie, grown rich off trade."

Schumpeter (1912) puts less faith in entrepreneurs' ability to procure advantageous marriages. He argues that the social purpose of financial markets and institutions is to put capital in the hands of people with economically viable business plans, and that technology-driven growth is very difficult without tandem financial development. Consistent with this, King and Levine (1993) show that countries with better-developed stock markets and banking systems continually reallocate capital to finance visionary entrepreneurs and thereby grow faster. The studies in this volume largely support King and Levine.

Energetic stock markets are associated with the entry of new firms and corporate governance entrusted to new entrepreneurs. Sleepy stock markets are associated with a freezing of cast. Morck et al. (chap. 1) show that Canadian stock market booms correspond to periods of energetic entrepreneurial activity. Aganin and Volpin (chap. 6) stress the importance of Italy's stock markets a century ago in financing her first generation of great industrial corporate groups. Högfeldt (chap. 9) argues that Sweden's socialist governments weakened her financial system, locking a corporate elite in place, and that this ultimately retarded economic growth. Rajan and Zingales (2003) argue that yesterday's entrepreneurs often lobby to weaken financial markets as a way to deter competitors from arising. While none of the studies in this volume reports direct evidence of such lobbying, the argument is plausible. To distort Mark Twain only slightly, "The radical of one century is the conservative of the next."

Shleifer and Wolfenzon (2002) argue that active stock markets affect corporate governance by letting wealthy heirs sell out, and this is confirmed in several chapters. Becht and DeLong (chap. 11) describe how American stock markets deepened and broadened to finance first railways and then industrial firms too. This permitted trust promoters to float shares to buy out founders or their heirs in a wave of takeovers. Other American families sold out incompletely, keeping a tenuous grip on their companies with relatively small ownership stakes or board seats. Morck et al. (chap. 1) describe similar events in Canada. Aganin and Volpin (chap. 6) describe a boom on the Milan Stock Exchange at the beginning of the twentieth century caused by the Banca Commerciale and Credito Italiano, which helped numerous entrepreneurs raise capital by selling shares on the stock market. They go on to note that, by 1907, 72 percent of the total equity of all Italian limited-liability firms traded on stock markets.

Irrational exuberance in America's stock markets may also have helped disperse corporate ownership in that country. Becht and DeLong (chap. 11) echo Dewing (1919) and argue that the American stock market gave founders and heirs the chance to sell their stock for more than it was worth. "Physicians, teachers, dentists, and clergymen" constituted "the happy hunting ground" of the "sucker list," where people were persuaded to buy "highly speculative and worthless securities" by "devious and dubious" methods. Stock market booms in other countries may have played similar roles. Morck et al. (chap. 1) describe Canadian families selling out into the overheated market of the late 1920s and a consequent increase in the importance of widely held firms.

Where shareholders' property rights are insecure, trust commands a premium. Becht and DeLong (chap. 11) argue that American shareholders at the beginning of the twentieth century had "virtually no statutory legal rights, and so favored companies controlled by men of good repute and accomplishment, such as J. P. Morgan and his partners, who charged handsomely for monitoring services." Under these circumstances, stock markets expand the governance sway of established families. Pagano, Panetta, and Zingales (1998) report that, from 1983 through 1989, the number of listings on the Milan stock market grew more than 50 percent, but that most of the new listings were subsidiaries of traded companies going public to take advantage of booming stock markets. Khanna and Palepu (chap. 5) point to similar developments in postindependence India and argue that established families backed entrepreneurs by helping them build listed companies within established family pyramidal groups.

Where stock markets are ill trusted, banks can channel financing to entrepreneurs and monitor corporate governance. However, this seems to have played an important role in only a few countries. The chapters on Britain, Canada, and the Netherlands highlight how commercial banks in those countries entered the era of industrialization with strong attachments to the *real bills doctrine,* which mandated that banks lend with trade goods as collateral. This let banks enthusiastically fund trade but kept them from financing industrial plant and equipment. Branch banking restrictions and the Glass Steagall Act of 1933 kept American commercial banks to a minimal role in financing large corporations. Memory of the Crédit Mobilier fiasco apparently kept British banks out of investment banking too. In contrast, German, Japanese, and (later) Swedish banks eagerly financed industrial development. In the case of Japanese banks, this was despite an analog of Glass Steagall imposed by Macarthur in the postwar period.

Aoki (1988), Kaplan (1994) and others argue that bankers can be sophisticated monitors of corporate insiders and thus reliable guarantors of good corporate governance. However, Morck and Nakamura (1999), Morck, Nakamura, and Shivdasani (2000), and others argue that bankers' aim in governance oversight is to make sure corporate borrowers repay their debts. This could induce excessive risk aversion and excessive investment in tangible collateralizable assets, rather than knowledge-based assets. Banks and other financial firms are also biased as monitors of corporate governance because they see firms as customers too. De Jong and Röell (chap. 8) make this point succinctly, quoting an insurance company representative thus: "You are in a difficult position if you want to present a new contract to the management board whilst you have voted against one of their proposals the day before."[28]

Fohlin (chap. 4) argues that German banks' contribution to corporate governance is often overstated. Kleeberg (1987, p. 134) agrees, noting that "German industrialization advanced rapidly in the late nineteenth century, but probably depended more on old family wealth than on bank loans." Where bank financing was important, he questions its economic effects, noting (p. 404) that "an unfortunate result has been that often the most successful captains of industry in Germany have not had any particular talent for industry or marketing, but rather were skilled at handling the banks."

Finally, this volume makes it clear that financial development is not a given but depends on politics and history. China's first attempt to develop a modern financial system was a serious initiative that ran afoul of her ancient entrenched bureaucracy. Murphy (chap. 3) argues that France's train of financial crises made her people leery of capital markets and induced her politicians to overregulate them. Pointing to a constricted financial system as an explanation for highly concentrated corporate governance is inadequate, for this begs the question of why a country's financial system is what it is. Chapters 10 and 11 show how politicians responsive to demands by investors made the financial systems of the United States and United Kingdom, respectively, what they are.

Politics

The studies in this volume are unenthusiastic about direct political involvement in corporate governance. But they also testify to the importance of government in establishing and sustaining the legal and regulatory infrastructure needed for sustained good governance.

From a historical perspective, entrusting corporate governance to the state evokes the Axis powers' policies in the 1930s and 1940s, described in this volume by Aganin and Volpin (chap. 6), Fohlin (chap. 4), and Morck

28. D. Brilleslijper, Delta Lloyd spokesman, in *FEM Business,* 20 September 2003.

and Nakamura (chap. 7). While the forms of private ownership survived, effective control rested with party and military representatives on boards. From a theoretical viewpoint, Boycko, Shleifer, and Vishny (1996) argue that state control leads to excessive employment. Krueger (1990) argues that political patronage inflicts inferior governance on state-owned enterprises. Consistent with this, Dewenter and Malatesta (2001) find significantly depressed profitability in state-owned enterprises.

One state role in corporate governance that has not yet attracted much attention from researchers is the pyramidal group of listed companies with a state-owned enterprise at the apex. Aganin and Volpin (chap. 6) argue that the "wasting of resources" by state-controlled pyramidal groups of listed companies in Italy was an important cause of that country's economic crisis in the 1990s. Morck et al. (chap. 1) refer to scandalous governance problems at the Caisse de Dépôt et Placement du Québec, a provincially controlled pyramidal group in Canada. Further work is needed to clarify the political purposes of these structures and to understand better their governance and economic impact.

Despite their skepticism about direct political involvement in corporate decisions, many contributors stress the power of the state to despoil or distort corporate governance. Rajan and Zingales (2003) argue that the stock market can be either fostered or hampered by government action, depending on the balance of powers between pressure groups. Khanna and Palepu (chap. 5) describe the License Raj as a "Kafkaesque maze of controls [having] more to do with a heady fascination with the intellectual cuisine of the London School of Economics and Cambridge . . . and the wonder of the then ascendant Soviet planning machine, than with the actions of India's dominant family businesses. Business groups had to either manipulate it, as some did, or invent themselves around it, as did others." Aganin and Volpin (chap. 6) likewise stress the role of politics in Italian corporate governance through the century.

Ghemawat and Khanna (1998) argue that business families control business groups to extract personal gains and attain their position through directly unproductive economic activities and through their influence over government policies and actions.[29] Pagano and Volpin (2001) and Biais and Perotti (2003) argue that state intervention in the economy should be negatively correlated with financial development, because the state acts as a substitute for financial markets. Högfeldt (chap. 9) proposes a similar history in Sweden, where the Social Democrats let the financial system wither like an unnecessary appendix. Aganin and Volpin (chap. 6) emphasize how little Italian stock markets mattered mid-century, noting that "from 1950 to 1980, between 15 and 20 percent of traded companies in Italy were

29. Morck, Wolfenzon, and Yeung (2004) develop several more arguments along these lines and assemble a range of empirical evidence about their scope of applicability.

controlled by the government. The correlation between the two series is –70 percent."

Entrenchment

Finally, the studies in this volume all point to a commonality in human nature. Elites are self-interested and cooperate to entrench themselves—even at considerable cost to their economies and to themselves in forgone opportunities to grow richer. Becht and DeLong (chap. 11) explain how American controlling shareholders and professional managers took control of the board nomination process to all but give themselves ironclad tenure. Morck and Nakamura (chap. 7) describe how the builders of Japanese *zaibatsu* family pyramids viewed those structures as devices to lock in control, and how postwar *keiretsu* groups developed to block hostile takeovers that threatened corporate insiders' positions. De Jong and Röell (chap. 11) argue that Dutch corporate insiders developed an array of *oligarchic devices* to limit shareholders' power to fire them. Franks, Mayer, and Rossi (chap. 10) describe how British corporate insiders tried unsuccessfully to erect pyramidal business groups to similarly entrench a status quo that bestowed privileges upon them. Fohlin (chap. 4) depicts German banks safeguarding their control of corporate proxy voting to entrench the power of leading bankers. Aganin and Volpin (chap. 6) relate how elite Italian business families entrenched themselves. Chapters 2, 3, 5, and 9 describe bureaucrats destroying wealth to lock in their power. In the case of Sweden, Högfeldt argues that wealthy families ultimately cooperated with public officials in a sort of "mutual entrenchment" pact. Mody argues, in his discussion of the chapter on India, that a similar confluence of self-interest occurred in India, and Morck et al. (chap. 1) speculate that something analogous might have happened in Canada in the latter twentieth century.

A predisposition to invest in entrenching one's position is consistent with recent research into the nature of self-interest. *Prospect theory,* proposed by Kahneman and Tversky (1979), holds that individuals view upside and downside risk asymmetrically. A preponderance of empirical and experimental work, surveyed by Shleifer (2000), now supports prospect theory as representative of typical human behavior.

Prospect theory makes people loss averse. That is, people typically place a higher subjective value on avoiding a $100 loss than on gaining $100 of additional wealth.

In this light, pervasive entrenchment seems almost inevitable. For entrenchment is precisely about sacrificing opportunities for further gain to minimize the risk of loss—archetypical self-interested behavior according to prospect theory. The patriarch of a large family firm can either support or oppose institutional reforms, such as more efficient capital markets or courts. These changes might let the patriarch greatly expand his family business group and grow much wealthier, but they also might let competitors arise who might erode or even destroy the family's established wealth. Large risks of this sort, according to prospect theory, are typically rejected even if they entail substantial upside potential. Risking the patrimony is simply unacceptable. In contrast, minor tinkering with institutional change is typically acceptable. Prospect theory thus suggests a conservative bias that would encourage wealthy patriarchs to invest in entrenching themselves and oppose institutional reform that might risk their current wealth and status. If political power is largely in the hands of the currently wealthy, Kuran (1988) predicts a locking in of the status quo. Olson (1963, 1982) suggests that this is likely to be the case, as does Faccio (2003).

But ordinary citizens might also entertain a bias against institutional reform. Murphy (chap. 3) shows how various attempts to reform the French financial system led to repeated disaster. If most people view institutional change as carrying a substantial probability of making things worse, populations as a whole might likewise favor the status quo.

Another key element of human nature, first demonstrated in experimental work by Milgram (1963, 1983), is an apparently reflexive obedience to perceived legitimate authority.[30] It seems likely that this behavioral response stabilizes family capitalism throughout much of the world, especially where wealthy families who control large business groups are closely intertwined with the state and so have reinforced legitimacy.

Third, the economy requires a degree of institutional stability. Commons (1924) argues correctly that business planning is impossible if critical institutions are uncertain. Business is often easier with certain but unfavorable laws than with uncertain favorable laws. Owen and Braeutigam (1978) argue in this vein that people holding uncompleted contracts perceive themselves as having a right to the continuation of existing institutions, and so oppose change.

All of this might explain the one-sided institutional momentum that is evident throughout the studies in this volume. Institutional reform that locks in the status quo seems easy. Institutional reform that brings real change is rare. China's first attempt to import Western legal institutions failed because it threatened the powers of her ancient bureaucracy. The reforms were either ignored or modified to protect the bureaucrats, and so they failed to bring sustainable free enterprise to China. America's attempt to impose freestanding widely held firms on postwar Japan likewise failed because their professional managers saw their status at risk because of threatened hostile takeovers. Those managers reconstituted corporate groups to lock in the status quo. India's License Raj, Sweden's Social Democracy, and perhaps Canada's post-1960s Statism were all arguably attempts at radical reform of various sorts that ultimately entrenched corporate elite families.

30. For a quick summary, see Morck (2004a).

Real reform seems to have succeeded in 1930s America—perhaps because people thought they had little more to lose given the disaster of the Great Depression. A small loss balanced against a large gain can induce people to take the bet and support institutional change. In America, they apparently won. Similar willingness to bet in 1930s Germany, Italy, and Japan turned out less happily.

Prospect theory is not the only possible underpinning for a conservative bias against institutional change. Roe (1996) argues that institutions might suffer from a QWERTY effect, whereby institutions, like keyboards with which everyone is familiar, are retained because the cost of adjusting to new ways exceeds the benefit—at least in the short term.[31] Day (1987), Heiner (1983, 1986, 1988), and others argue for a conservative bias based on bounded rationality and computation costs.

All of this has several implications. First, real institutional change is difficult, but not impossible. Overcoming a popular conservative bias is easiest during crises, when people feel they have less to lose should the reform go wrong. Second, countries will not easily mimic each other, so variation in institutions across countries with different histories will not disappear easily—even if one system appears better. Third, institutional change, even when implemented enthusiastically from above, as in precommunist China, may fail because of a popular conservative bias. Institutions that sustain great inefficiency, inequality, and even corruption may thus be quite historically stable.

Conclusions

History, like poetry, does not repeat itself, but rhymes. Accidents of history give the rhyme a different starting point in different countries, but there is a common meter throughout.

Financial disasters tainted French confidence in financial securities early on and set corporate governance in that country on a different path from that of Britain, where similar trauma was overcome and forgotten. Why trauma desolates some people and some nations, while others pick up the pieces and move on, is profoundly unclear. But history is more than a string of accidental traumas.

Ideas matter. There is a conservative bias in every country that impedes institutional change. But when crisis strikes, that bias lessens and change is possible. Whatever idea is waiting in the wings at that time can be swept into reality. Thus, American Progressivism, German National Socialism, Italian Fascism, Japanese militarism, and Swedish Social Democracy all became incarnate during the depressions of the 1920s and 1930s.

Families matter. Throughout the world, big business was, at first, family

31. Though see David (1985).

business. It seems likely this arose because blood kin can cooperate more reliably than nonkin. Reliable cooperation is important in countries at early stages in their economic development, when legal and regulatory institutions are unreliable guarantors of trustworthy behavior. But this, too, is admittedly speculation. For families remain overwhelmingly important in the governance of the large business sectors of all but a handful of developed economies. Perhaps this reflects a conservative bias against change, or perhaps many developed countries still do not have institutions that foster an ambient trust. Or perhaps there are other explanations, like inherited talent, that we find intellectually uncomfortable.

Business groups, each encompassing many separately listed firms, became important in almost every country, including the United States, at some point, and they remain important in most developed economies. These groups almost always have a pyramidal structure, with a family, family partnership, or family trust at the apex. To some extent, these structures were probably hierarchical arrangements designed to span dysfunctional markets in the early stages of economic development, and these explanations perhaps retain validity in modern emerging economies. But the ubiquity of large pyramidal family-controlled business groups in Canada, Japan, and most of Western Europe is harder to square with this theory. Those countries have had many decades of high income and could surely have repaired such problems had they wanted to. It seems likely that pyramidal business groups of listed companies survive in wealthy countries because they lock in the corporate governance power of an elite family over capital assets worth far more than the family fortune. That power brings intangible benefits that such families are loath to surrender.

Wealthy families, to lock in their corporate governance, might block the emergence of trustworthy markets and institutions, and so greatly harm their countries. Or they might persist as a sort of corporate governance appendix while institutions and markets develop around them. Or, like constitutional monarchs, they might serve shareholders by providing constitutional guarantees of good governance, and so contribute to higher levels of trust. Or might business acumen sometimes actually pass down through families? Each possibility was probably realized at different times and in different countries.

Law clearly matters, though just how is less than clear. Many current differences between common-law and civil law countries regarding statutory shareholder rights are not long-standing differences.[32] This volume advances our understanding of the different manifestations of capitalism throughout the world. By adopting a historical approach it provides useful insights into how various economic institutions, and institutional configu-

32. See Lamoreaux and Rosenthal (2004) regarding the dearth of shareholder rights in the pre-Depression United States.

rations, came to be. It also engenders some general observation regarding varieties of capitalism and economic change.

Legal systems are not the only features that distinguish former Western colonies from each other. Perhaps vestiges of indigenous institutions mount an immune response against transplanted Western institutions. Or perhaps radical changes in institutions invite problems. Patterns in current corporate governance sometimes attributed to legal system origins may reflect other historical antecedents.

Institutions in every country studied evolved through time, and corporate control changed with them. What caused what is often unclear, though. Many countries now considered to have highly trustworthy institutions, including institutions of corporate governance, were profoundly corrupt only a few generations ago. There seems to have been an evolution toward ever less popular tolerance of corrupt elites everywhere, except perhaps in Britain.

Where reformers sought to hasten that evolution by transplanting institutions from one country to another, success has varied. Although Western institutions grafted onto Japan quickly took on a native appearance, the grafts surely did not fail. Japan is a highly prosperous economy, and few countries are so devoid of governance and other scandals as to denounce its institutional experimentation as a failure. Western institutions grafted onto prerevolutionary China failed spectacularly, and those grafted onto India long looked sickly but recently seem invigorated.

Large outside investors, such as pension funds, are becoming important throughout the world and may well have a salubrious effect on corporate governance everywhere. However, it is hard to see how success in influencing the professional managers of widely held firms in the United Kingdom or United States need imply similar success in influencing old moneyed families with control blocks in scores of firms in a more typical country. Yet wonders happen.

Financial development seems intimately tied to corporate governance, with more developed financial systems associated with more professional management, more diffuse shareholders, and less ubiquitous family control. But these correlations are only rough, and many counterexamples arose in the histories of many countries. For example, family groups rose and fell in importance in Italy, while financial development fell and then rose—consistent with the general cross-country pattern. But family groups fell and then rose in importance in Canada, while financial development probably mainly rose.

Politics perhaps explains some of this, for large family groups may be better at dealing with more interventionist governments than multitudinous freestanding firms. Or politicians bent on interventionism may value being able to influence the whole corporate sector with phone calls to a handful of patriarchs.

Perhaps because business elites and political elites tend to overlap, institutions, including those that pertain to corporate governance, seem hard to change, except to lock in more solidly the status quo at any point in time. A common theme through all the countries surveyed is entrenchment—corporate insiders modifying the rules to minimize the chances of becoming outsiders. This is so ubiquitous that we propose that something basic in human nature must be involved.

An ultimate bottom line for this volume is that history is best enjoyed vicariously. Institutional change and, even worse, experimentation, though enlivening the studies in this volume, have often been disastrous to those involved. This too may explain the institutional momentum apparent in every country. Certainly, it cautions against overly optimistic plans for top-down structural reforms to corporate governance in developing countries. But successful reforms dot history, and Japan's wholesale transplanting of Western institutions can scarcely be called a failure. History need not be the handmaiden of authority.

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