MEANINGS OF CORPORATE GOVERNANCE AND DYNAMICS OF INSTITUTIONAL CHANGE: THE THESIS OF CONVERGENCE REVISITED

ADELINO FORTUNATO
Associate Professor
Faculty of Economics and GEMF, University of Coimbra
Avenida Dias da Silva, 165
3000 Coimbra
Portugal
adelino.fortunato@netvisao.pt

ABSTRACT

Some authors, notably the Chicago School economists, argue that globalization and world competition are inducing different systems of corporate governance to converge with the standard model, based on efficient market institutions, on maximizing shareholder value, on a more dispersed ownership structure, on the relevant role of minorities and other market control mechanisms like takeovers, and high liquid stock markets. They see corporate governance systems as products or technologies fighting for survival, and consider that institutional arrangements which overload firms with excessive costs are doomed to disappear.

For other researchers, however, worldwide difficulties experienced by economies and corporations justify two specific different ways of convergence: convergence into a new model, taking advantage of the ‘best practices’ of different corporate governance systems, by transferring and adapting organizational and legal characteristics and practices of different systems with the objective of reducing costs (AOKI, 1990); or convergence by juxtaposing different models, homogenizing practices without formal convergence,
because it is much more difficult to make formal institutions homogeneous than it is to adopt certain world dominant practices (GILSON, 2004). Hybrid models will always result from both these types of convergence.

Finally, others like Bebchuck and Roe (2004) or Bratton and McCahery (2002), consider that path dependence or local identities will imply the persistence of strong differences between formal and informal institutions of corporate governance, because even admitting the heroic hypothesis of worldwide adoption of the same principles and rules, in contexts with divergent histories, traditions and cultures different consequences will always prevail.

It is argued here that this debate about convergence and its opposing prognoses is actually another one. It is a debate about the different meanings of corporate governance, because the literature is not consensual regarding the extent and complexity of institutions involved in different views: the more comprehensive and systemic the perspective is, the less the enthusiasm about the convergence thesis of corporate governance systems all over the world.

KEY WORDS: convergence, corporate governance, institutional change, innovation, innovative firm

Code of the Research Area: C (Institutional change)
MEANINGS OF CORPORATE GOVERNANCE AND
DYNAMICS OF INSTITUTIONAL CHANGE: THE
THESIS OF CONVERGENCE REVISITED

INTRODUCTION

The OECD Principles of Corporate Governance were first published in 1999 (republished in 2004), a collection of recommendations adopted not only by OECD members but also by other organizations and countries. The World Bank and the Financial Stability Forum, for example, trying to manage international financial stability, followed that publication regarding the evaluation of firms’ governance practices for emerging markets. The Principles are not oriented towards the suggestion of a unique model of corporate governance, “the purpose is to serve as a reference point. They can be used by policy makers as they develop their legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances and by market participants as they develop their own practices”.

Apparently that is what has been done all over the world through Codes of Good Governance, a method initiated in 1992 by the Cadbury Report in the United Kingdom, following the London Stock Exchange and The Financial Report Council appeal. This reform movement was well justified by the financial and stock scandals revealed in the USA (cases Dynergy, Qwest, Enron, WorldCom, Global Crossing and Tyco cases) and Europe (Seat, Banesto, Metallgesellschaft, Suez, ABB, Swissair, Vivendi) since the 1990s (TIROLE, 2006). But it is not possible to detach that process of reform from the deep economic, political, social and institutional changes that occurred since the 1980s as a consequence of the so-called globalization. This is why the nuances of the debate
about the evolution and path of different corporate governance systems acquired a
dynamics that exceeded the Principals’ initial intentions, becoming a controversy with
wide-ranging implications for the institutional future of modern economies.

Some Chicago School economists (MILLER, 1997; EASTERBROOK, 1997; MACEY,
1998), drawing on neoclassical microeconomic assumptions, implicitly sustain that
governance reforms through reference to different systems would be spurious. As it is
market product competition that determines firm survival, any governance arrangement
that overloads a competitor with excessive costs will cause failure and may become
untenable. Firms must choose optimal governance arrangements in order to survive, and
governance problems take care of themselves in the long run (BRATTON and
MCCAHERY, 2002). In the absence of political barriers and as a consequence of the
worldwide intensification of competition we shall see an evolutionary convergence
towards the most efficient system, with better properties of competitive fitness that will
achieve hegemony after a period of competitive struggle - the standard model based on
best practices, on a dispersed ownership structure, liquid markets, an efficient market
for corporate control and on relevant role of the stock markets.

But others believe that the difficulties experienced by firms in distinct corporate
governance systems constitute an appeal for changes that draw from the best and most
efficient aspects of each, supporting a movement that converges in a new model or in
juxtaposing different models. In the first case, the appearance of a new model, we
would see to the transfer and adaptation of legal and organizational components, as well
as practices from different existing systems, aiming to solve concrete cost reduction
problems (AOKI, 2000). In the second case, the juxtaposition of models, we would see
the convergence of practices without formal convergence, because it is easier to make
firms’ conduct homogenous than to overcome resistance to formal institutional
convergence (GILSON, 2004). Whatever the case, and comparing the most representative corporate governance systems, the result would always be the emergence of a hybrid model, by means of systems convergence or by the duality between functional adaptation and institutional persistence.

Lastly, we have authors who are usually skeptical about the convergence thesis which could be included in a residual stream well-known for its acceptance of notions like path dependence (ANTONELLI, 1997) or local identity (BRATTON and MCCAHERY, 2002). Rejecting any technological determinism involved in strong convergence hypotheses, they instead posit that there may be more than one way to solve a given problem and different national systems of production may be functionally equivalent. Even accepting the heroic hypothesis that the same set of some legal and organizational rules and formal institutions could be adopted all over the world, strong differences would always persist in other formal and informal institutions of corporate governance. This is mainly because the same rules and organizations and general principles adopted in contexts with different traditions, cultures and institutional environments will lead to different consequences (BEBCHUCK and ROE, 2004).

This debate is important not only to clarify conceptual and theoretical doubts but also to evaluate the impact of environmental differences on potential opportunities for the growth of contemporaneous firms and economies. In this article, in addition to pointing out institutional differences and how these relate to firms’ performances, I want to show why the debate is influenced by a misunderstanding that distorts the efficacy of its arguments and conclusions. In fact, different notions of corporate governance should be compared with one another, as a matter of urgency, because opposing prognoses for convergence are determined by the extent to which institutional mechanisms are involved in the analysis. The narrower and less systemic the conception, the bigger the
enthusiasm for the convergence thesis of corporate governance systems all over the world. But it is quite the opposite, if we accept that the notion of corporate governance includes a “nexus of institutions”, the more we move away from the convergence hypothesis.

With this aim in view, I will first develop different meanings of corporate governance and examine its relationship with the main theories revealed by the literature. In Section 2 I will review the theoretical justifications for why there are different systems of corporate governance; in Section 3 the hypothesis of convergence will be discussed, while Section 4 will demonstrate the limits of the debate about convergence, and then in the last section some conclusions will be drawn.

MEANINGS OF CORPORATE GOVERNANCE

Corporate governance mainly implies an economic, organizational and legal series of issues related to systems, principles, mechanisms or institutions through which firms are owned, managed and financed. However, the specific way this subject is approached and developed depends on the economic, historic and institutional framework, as well as on some theoretical fundamental conjectures and the objectives in view. This is why we can only understand what really is at stake with the meanings of corporate governance by analyzing their main perspectives and some plausible justifications for those in force worldwide diversity of models.

Shareholder Perspective

To take advantage of the economies of scale and scope created by the large American market of the nineteenth century firms looked for a dispersed financing, forcing a managerial revolution where companies’ learning and organizational structures trained
and rotated top managers during their careers in pursuing innovative investment strategies. One of the leading consequences usually mentioned was the separation of ownership and control and the appearance of agency costs supported by risk-bearing dispersed capital suppliers (principals) to supervise and control risk-averse top executives (agents). As Shleifer and Vishny (1997) observed, literature on corporate governance focused on finding “ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment”, which is equivalent to saying that it became centered on a small portion of the institutional features of the corporate economy. The declared agenda for corporate governance is to design an incentive program, or an optimal incentive structure for sharing the risks between the agent and the principals, and to ensure control mechanisms that align executive behavior with the intention of maximizing shareholder value.

This perspective is the conventional view on the subject of corporate governance and it is sometimes taken as the narrower conception, because its definition and preoccupations stayed at a low level of systemic institutional complexity. It is supported by a theory of contracts and theory of finance to draw up a contingent system of incentives that align agents’ interests with those of principals. Furthermore, complemented by rules and market mechanisms, such as an appropriate structure and composition of board of directors, proxy fights, an efficient market for corporate control, legal rules favoring the activism of minorities, it is adjusted to the role of disciplining top managers in the interests of maximizing shareholder value. Always appealing for market control and the special influence of outsiders, the shareholder perspective of corporate governance is well suited to the regulation of liquid stock markets based on ownership dispersion as was described by the pioneering work of Berle and Means (1932).
Relational View

According to La Porta et al (1999) in Germany and other Continental European countries, or in Japan and other Asian countries, or even on other continents where European influence was determinant via colonization, large firms reduce agency costs through the direct control over top executives exercised by banks, the state and other big shareholders, sometimes in conjunction with other stakeholders. Stakeholders like employees, lenders, material and equipment suppliers, dealers, communities all invest in a specific relationship with a company, bearing the appropriate risks that are not protected by “complete” contracts (BLAIRM, 1995). Because stakeholders share residual risks with shareholders, they have an interest in being able to exercise some control over corporations, contributing to competitiveness with their experience and social cohesion. As in the shareholder perspective, the process of optimal resource allocation takes place through the individual incentives given by the market to input suppliers, the difference being in the additional institutions required to ensure the control rights, the rewards and the responsibilities compatible with inducing firm-specific investments. In methodological terms the difference between the two approaches it is not very marked, and it is possible to formalize the stakeholder relationship with managers in a principal(s)/agent(s) framework as in Laffont and Mortimore (1997). But the consequences in terms of firms’ objectives and governance are quite clear: in the relational view managers are obliged to internalize the welfare of all stakeholders, and corporate governance means the design of institutions to define the rights and responsibilities of stakeholders, and how risks and incomes are allocated between them (AOKI, 2000). It is an intermediate notion in terms of the systemic institutional complexity, compared with the shareholder perspective and the conceptions I am going to consider below.
Organizational Control Theory

In spite of their differences, the shareholder and relational perspectives of corporate governance share a neoclassical conception of optimal individual resource allocation, concerned with a stable context where innovation is absent. To take the required exigencies of a changing environment explicitly into account we need a theory of resource allocation that includes a cumulative and collective learning process linked to a theory that conceives the firm as a bundle of routines rather than a “nexus of contracts”. The learning process is collective, in the sense that it evolves as a result of the interaction between individuals and groups of individuals in a specific firm, and that is why its members acquire a specific knowledge that is not easy to transfer. This implies organizational control over the critical factors of knowledge and financing, because of the cumulative and long-term nature of the learning process required to assure continuous innovation.

This means a specific relationship between insiders and outsiders that enable the company to take advantage of innovative experience, in conditions that are opposed to pressures of market control that are typical of the shareholder view of corporate governance. In the mutable environment of the developed countries the structural idea that determines governance agenda is the need to coordinate innovative investments, and corporate governance means the system of institutions that sustain a firm’s innovation in different historic periods, through dynamic changes (O’SULLIVAN, 2000). Because of the implications for related areas such as corporate law and the regulation of financial and labor markets, the organizational control conception involves a high degree of systemic complexity.
Life Cycle Theory of Corporate Governance

Corporate governance must also focus on the small and younger-managed firms (and not only on issues raised by large and mature firms), especially those reaching a point where they are beginning to face constraints on their ability to realize growth opportunities, and must be viewed as a dynamic system that may change, since firms evolve over different stages. In order to survive, a firm’s evolution involves changes in ownership structure, board composition, the degree of founder involvement, the functions of monitoring and control, the balance between stakeholders, organizational control and innovation, and strategic behavior.

The life cycle theory of corporate governance concerns innovation and dynamic changes of governance over the different stages of a firm’s life. Firm evolution and growth requires a permanent interaction with the external environment via a process of organizational learning and capability development, as well as through reactions to the strategic and institutional environment. Corporate governance means the design of institutional dynamics and changes that accompany organizational evolution, combining an agency’s problems with a firm’s strategy throughout its life cycle; but it is also related to the learning process that enables management to exercise entrepreneurship. It is therefore essential to extend the understanding of governance issues beyond the finance perspectives “to embrace both learning and knowledge dimensions as well as contextual issues” (FILATOTCHEV and WRIGHT, 2005), in an enlarged systemic view that embraces the notion of “nexus of institutions” (CIOFFI, 2000) in their definition because of the implications for different areas and institutions.
WHY DIFFERENT SYSTEMS OF CORPORATE GOVERNANCE?

It would be very difficult to understand the dynamics of institutional change in corporate governance if the debate about the origins of systemic differences is neglected. Although the literature it is not abundant in answers to the important question of why did emerge different systems of corporate governance all over the world, recent research has given us some useful additional information. We can catalogue the arguments in three main areas.

The Argument of Legal Families

The first argument deals with the idea that legal systems matter for corporate governance (LA PORTA et al. 1997), i.e. the degree of investor protection varies from country to country and depends on Common Law or Civil Law traditions. Common Law countries of English origin are most protective of shareholders and creditors, French Civil Law countries the least, and the German and Scandinavian civil law countries come somewhere in the middle. Glaeser and Shleifer (2002) argue that these traditions came from old – 12th and 13th century - different balances between local interests and centralization: the greater the pressures on courts to rule for the stronger rather than the just, the more centralization is needed to counter these pressures. England was relatively peaceful and the king maintained control over the entire country, while in France local notables were able to subvert all local institutions to their advantage. England adopted a Common Law system because decentralized adjudication could be successfully enforced, while France adopted a Civil Law system, sacrificing of the benefits of local knowledge, because only more centralized resolution was enforceable (DJANKOV et al 2003). The most obvious implication for modern corporate governance systems from such traditions is that greater legal protection of
minority owners is related to a more decentralized and dispersed model of shareholder involvement and to less need for ownership concentration, which increases companies’ access to external finance, and reduces capital costs but increases agency costs. Meanwhile, less protection of minorities is associated with greater ownership concentration and a more stable and centralized pattern of companies’ shareholder investment, which blocks stock markets and impedes diffused access to capital, but diminishes agency costs.

The Argument of Politics

Roe (1994) enhanced the specific institutional and regulatory characteristics of the USA, always restrictive in terms of banks’ involvement in controlling and holding shares in corporations. And the same could be said of the suspicion about national expansion of a centralized and concentrated system of big banks, which culminated in the Glass-Steagall Act interdiction of combining commercial and investment banking. Additionally, the limitations on horizontal mergers created by anti-trust law up to the Celler-Klefauver Act stimulated the non-related pattern of firm diversification typical of the large American conglomerates, with dispersed ownership and organization M-form organization, as Chandler called it. Modern regulation in America produced big corporations through external growth, using the stock market to obtain the necessary financing from dispersed shareholders; while in Germany or Japan big corporations were mainly created via internal growth, using banks or large shareholders and favoring the creation of new competences for managers and workers.

Secondly, Roe (2000) emphasized the role of social-democratic political regimes in Continental Europe that gave priority to equity, to dispelling inequalities, preserving employment, favoring workers, pressing managers for objectives others than
maximizing shareholder value. This means that managers’ behavior was misaligned with the interests of shareholders in a context where the dominant political culture contemplated different stakeholders, like workers, and created high potential agency costs that were diminished by ownership concentration.

Finally, Gourevitch and Shinn (2005) considered the implications for corporate governance structures of countries’ differences in terms of political institutions, from the perspective of how majoritarian or how consensual their rules and practices are. Majoritarian systems magnify the impact of small shifts of votes, thus allowing large swings of policy, while consensus systems reduce the impact of vote shifts by giving leverage to a wide range of players through coalitions, having smaller policy swings. As majoritarian systems have fewer veto players, they may be expected that to endue diffuse patterns of corporate ownership and flexible strategies; while the opposite would be true in consensus regimes, where stability perspectives encourage block holding and firm-specific investments in a relational and long-term involvement of stakeholders.

The Argument of Institutional Complementarities

Using the notion of institutional complementarities\(^1\), some authors suggest that there may be more than one type of capitalism, as different national systems of production may be functionally equivalent and persist over time. Drawing on social as well as economic theory, Hall and Soskice (2001) design national systems as packages of specific institutions, resources and paths, giving form to variation among national political economies in terms of labour market regulation, education, and training systems, and of inter-firm relations and corporate governance. The core distinction is between liberal market economies, where the firms’ arm’s-length exchange of goods

\(^1\) Two groups of institutions are said to be complementary when the revenues that can be taken from one of them are increased by the presence of the other (MILGROM and ROBERTS, 1990).
and services and an outsider (shareholder) model of corporate governance predominate; and coordinated market economies, where a relational model of networking and (inside) corporate governance prevail.

Similarly Aoki (2000), trying to analyse the advantages and disadvantages of different economic systems and potential gains from institutional diversity, finds a relation among corporate organizational architectures conceived as information systems, the institutional characteristics of the labour and financial markets, and models of corporate governance. Institutional complementarities may exist: between a liberal state, a competitive liquid labour market and a private employment contracting based on the efficiency wage hypothesis, as in the Anglo-American model; or between national corporatism and co-determination, as in the German system; or between “an imperfect labour market” regulated by firm-specific rules and team-oriented production, and the contingent control system of a main bank, as in Japan. In any case, corporate governance involves the internal structure of the firm, the financial system and the labour market in which it is embedded.

**CONVERGENCE WHICH WAY?**

The change in patterns of corporate governance analysed by the convergence hypothesis will be a highly complex process that may or may not go far beyond partial changes in corporate law or the securities market. It would imply a kind of institutional transformation based on the trend of different systems to adapt or approach to a single system. Strong hypothesis of convergence means radical one-sided adaptation to the most efficient model and components, while the weak hypothesis only means that institutional components in different models may change independently from each other, leading to the emergence of a hybrid system (LANE, 2003). Whatever the point
of view, we are talking about changing norms, rules, habits and collective and individual practices that are influenced by what Hodgson (2003) describes as “the more deeply hidden persuaders”, that are not “the products of any corporate marketing department, or government office, but are those that emanate in some way from our social institutions and our history”.

According to him, individuals’ behaviour is both constrained and enabled by institutions that can even mould and change their aspirations. There is a process of reconstitutive downward causation, stating that if there are systemic properties and tendencies, then individual components of the system act in conformity with them. However, institutions and systemic properties do not entirely explain individual behaviour. First, because particular human behaviour depends on causal processes operating at individual level, such as aspirations or dispositions, and second because there is also a reconstitutive upward causation: taking some limits imposed by previous background and more general dispositions, lower-level changes may influence a higher level structure. All this implies that convergence is a very complex and uncertain process, wherein formal transformations interact with individual or group resistances, and that the sign and results of systemic trajectories and changes may be not entirely predictable or equivalent when different systems are submitted to the same general constraints.

**Failed Convergence**

According to Hansmann and Kraakman (2004), pressures for the worldwide convergence of governance practices of large-scale business enterprises date back to the end of the nineteenth century, when every commercial jurisdiction established the corporate form with similar features. However, three factors played against strong convergence: first, differences in rules specifying how the interests of stakeholders other
than shareholders should be accommodated inside the firm; second, differences concerning the regulation of conflicting interests between controlling and non-controlling shareholders and third, differences in the detailed structure of jurisdictions, economies, business cultures, labour and financial regulation, and political traditions. The interaction among these factors worked for the emergence of different systems of corporate governance embedded in each country’s social and institutional structure.

The Marshall Plan and the process of reconstruction that followed the end of the Second World War, for example, pressured local authorities for convergence with the American model of corporate governance based on the wide dispersion of ownership structures, an important role for stock markets and active minorities, an efficient market for corporate control and the absence of a workers “voice” in corporate governance structures (DJELIC, 1998; GUILLEN, 1999). However, the institutional and historical specificities of the countries involved met against these recommendations and prevailed by means of complex and typical models.

In the German case, political and ideological connections with embryonic co-determination began early in the year of 1891, as an attempt to defend the rights of workers and attenuate the impact of liberal consequences of industrialization, with the legal establishment of work councils within companies on a voluntary basis (PISTOR, 1999). They gained in importance after the First World War, during the Weimar Republic, when they were included in the Constitution not only as entities of the firm, but also as political organizations that represented workers. These laws were rescinded during the Nazi regime, but were reinstated after the Second World War in conjunction with an extended participation of workers representatives in the supervisory board of big corporations, monitoring executive behaviour side by side with representatives of shareholders, and contributing to the key strategies of the company.
Co-determination became a demand of worker’s representatives in post-war Germany to prevent the dismantling of the large coal and steel industries (co-determination was later extended to other sectors), and sustain employment in most industrialized regions. They tried to convince the Allied occupiers and European neighbours that worker participation in the supervisory boards would neutralize the war dreams that prevailed during the Nazi period (ROE, 2000; PISTOR, 1999). This is why Hopt (1998) and Pistor (1999) seem to see the co-determination and national social-compact corporatism that regulates industrial relations as an institutional arrangement adapted to the objective of involving “capital and labour” on a consensual basis in the reconstructing tasks.

Similarly, after the Japan’s defeat in the Second World War American Occupiers imposed several conditions for the democratization of the political and economic environment, namely the dissolution of the Zaibatsu, suppression of non-financial holding companies and dispersion of shareholder ownership included in the Anti-Monopolist Law of 1947. However, such expedients evolved toward a complex institutional arrangement structure of corporate governance based on a relational nature, cross-shareholdings, team-production, firm-specific labour regulation rules, and the determinant role of state bureaucracy and of a main bank. This system has its roots on the war economy that worked during the decade of 1940s, based on the important role of state bureaucracy, banks and team-work, and in the collective memory of traditional rural habits (AOKI, 1990).

The merger between a shared information system and team-production, created the preconditions for a system of corporate governance where the goal pursued by managers was to mediate the various interests of stakeholders and assure employment stability for workers, rather than achieve dividends for shareholders (ALLEN and GALE, 2000). Another task was to provide the steadily growth of benefits and revenues for all the
firm’s members under the constraint of a “reasonable level of profits” (AOKI, 2006). The special nature of the system comes from the shift of control rights between the insiders and an outsider monitoring agent, contingent on the corporate value of the firm: in a financially distressed state a main bank decides whether to restructure the firm or liquidate it.

Successful Convergence

The forces of financial globalization and international competition are powerful and are leading to the harmonization of some economic and organizational practices and legal norms under very different systems. Some authors, perhaps exaggerating their real importance, found the last decade’s slow-down in the growth of European and Japanese economies and the good performance of the USA depended on corporate governance differences (HANSMANN and KRAAKMAN, 2004). However, it may be true that global competition puts firms regulated by different jurisdictions in direct competition and those adopting the standard model will have advantages in accessing financing for the development of new products and technologies from the stock markets, in quitting inefficient investments and in entrepreneurship. A derivative of this process will be the movement towards international accounting harmonization procedures which mainly converge with the International Accounting Standards and American requirements.

Hopt (2002), in an article that largely concentrates on European countries, but which can be extended to other regions, considers that common principles of corporate governance did in fact appear in the last decade in different systems. Two important examples are illustrated by the composition and structure of the Board of Directors and by takeover regulation. There is a clear movement towards the inclusion of independent
outside directors on one-tier boards, with special functions of monitoring and supervising managers, which is a signal of convergence with the traditional division into two-tier boards, comprising the management board and the supervisory board. The same can be said about the recommended allocation of the CEO’s and Chairman of the Board’s functions to different persons.

Takeover regulation also converged with British tradition in many principles associated with information and disclosure, takeover procedures, conduct during bidding, partial bids, and competing bids. The differences that subsist concern the neutrality principle of the board during bids and the requirement of a mandatory bid for all shareholders, because, contrary to the British tradition (and Continental European by imitation) American corporate law tolerates the Board of Directors defence against hostile takeovers and does not include the obligation of a mandatory bid. But these important specifics, which are intend to protect minorities, seem to be fairly insignificant when analysed in connection with the more dispersed ownership structure of American stock corporations that prevents the bidder from exercising control in his own exclusive interest (HOPT, 2002).

**OUTCOMES OF CONVERGENCE**

Based on this process of institutional change, a conceptual debate is currently going on about the degree and modalities of adjustment in different corporate governance systems (BRATTON and MCAHERY, 2002). What is at stake it is to know if verified transformations are a sign of radical change and strong convergence with the standard model of market institutions, or with a new model of mixed characteristics based on worldwide best practices; or if those changes may absorbed by existing institutions through simple adaptation while conserving the main differences, or if we are
witnessing the emergence of a hybrid model that juxtaposes functional convergence with institutional persistence.

*Convergence with One System*

The literature has four streams on this theme. The first, usually connected with Chicago School economists, who implicitly see convergence as the outcome of survival of the fittest governance practices in the global markets, means the disappearance of systemic differences in favour of the standard model (MILLER, 1997; EASTERBROOK, 1999; MACEY, 1998). In fact, reforms of different systems are either considered “irrelevant” or they go hand in hand with building high-powered market incentives and institutions, and with introducing safeguards against abuse, which are the dominant forces of the standard model. Despite the fact that even in the United States and Great Britain there is considerable improvement in corporate governance institutions, most of it is expressed in widening the scope of shareholder activism and perfecting the board of directors as the primary safeguard of shareholder interests. That is how we must understand the tendency noted by Hansmann and Kraakman (2004) for “convergence from both ends towards the middle”, with respect to board structure reforms that try to incorporate in single-tier boards a substantial role for independent outside directors, as in two-tier boards. When they talk about “The end of history for corporate law”, foreseeing the imminent possibility of convergence, they are really considering the small changes that can ameliorate the performance of the “shareholder-oriented or ‘standard’ model”.

*Convergence of Systems*

The second stream, which includes authors like Aoki (1990), Nestor and Thompson (2000) and Kester (1996), states that “each system can and should learn from the
others” and suggests a constructive convergence of systems toward standards of “best practice” that combine elements of different models. Ideally, best practice will lead to the simultaneous exploitation of high-powered market incentives associated with exposure to market discipline and the development of stable, long-term commercial relationships, with their attendant transactional efficiencies (KESTER, 1996). This hypothesis would have important implications: global competition would lead to the emergence of a hybrid best practice model in order to reduce firms’ costs. Assuming that each system has equal competitive fitness, and accepting that there are imperfections everywhere, each system must have divisible components that can be transferred over time.

Important examples include the above-mentioned reforms in the structure of boards and takeover regulation, but there are also regulatory reforms relating to the role of banks, in the American economy, which (since 1999) have allowed a more closer relation with corporate ownership by abolishing some of the restraints in the Glass Steagel Act (ALLEN and GALLE, 2000; THOMSEN, 2001). The role of banks has been changing in Japan and Europe too. In Germany there are some signs that large banks are reducing their shareholdings in the largest firms, driven by the influence of stock market mechanisms and in Japan the eclipse of the main bank system and the globalization of financial markets are forcing firms to rely on various financial instruments and to adapt to a new market environment (AOKI, 2006). Similar considerations may apply to the increasing importance of institutional investors, which is leading to a more concentrated ownership among outside owners in firms within the American economy, which means “convergence” towards European ownership structures; and the increasing separation of ownership and control and the use of stock options, which is a sign of “convergence” with the standard model of corporate governance.
**Functional Convergence**

Gilson (2004) and Coffee (1999) make a distinction between formal and functional convergence: firms’ behavior tends to converge in the international context through the adoption of the dominant practices that assure survival and growth, but without the formal convergence of governance structures. Determinants like the European Single Market and growth of stock markets, disclosure harmonization, institutional investors, international harmonization of accounting standards, migration to foreign jurisdictions and the imperatives of the global scale urge firms towards the convergence of practices. But factors like institutional inertia, rent-seeking, control premium, path dependencies, and institutional complementarities block formal convergence and favor the emergence of another kind of hybridization, one that is based on juxtaposition of different models.

Hopner (2004), for example, analyzing changes in the German model of corporate governance since the 1990s, says that some of its essential pillars, like co-determination, industrial relations and collective bargaining, have remained stable on the surface. But a closer look shows that they are also undergoing functional changes in adapting to new pressures and managerial strategies that can configure “a hybrid form of ‘enlightened’ shareholder value” model (JACKSON, HOPNER and KURDELBUSH, 2004). And Araki (2000) concludes that current transformations in the Japanese corporate governance system will only lead to the re-alignment of its dominant stakeholder framework - even if Japanese corporate governance model is apparently more vulnerable to environmental changes than the German or the American ones, because of its non-institutionalized/non-formal nature. He produces evidence of functional convergence with the shareholder value model in important features like the rapid
dissolution of cross-shareholdings, abolition of the main bank system, additional role for stock markets and employment instability.

**Persistence**

The fourth perspective in this debate rejects the global convergence that eliminates systemic differences or the emergence of a hybrid best practice, because each national governance system is a system to a significant extent, consisting of an interconnected collection of components and a complex incentive structure (BRATTON and MCCAHERY, 2002). If there is any convergence it will occur within limits set by national or local contexts, and its effects will be uncertain and varied, depending on specific institutional configurations related with markets, competencies, property rights and other legacies. All this means that market pressures induced by financial and market globalization continue to be mediated by the existing configuration of national institutions, preventing different systems from moving towards the same paths, trajectories and outcomes.

Partial adjustments reduced some differences, but considerable gaps between national systems of corporate governance will persist, mainly because choices made at a specific moment about ownership structures and legal norms depends on pre-existing ownership structures, legal norms and national cultures. Convergence will need to support high sunk costs, to build new institutional complementarities, to face institutional trajectories that may lead to multiple equilibriums and to suffer inertia from those who gain from impeding structural changes (BEBCHUCK and ROE, 2004). When the evolution of stochastic systems is path-dependent, some events – namely their initial conditions – may have long-term consequences that can only be modified in limited proportions, and this leads to uncertain and varied states (ANTONELLI, 1997; GEROSKI, 2000). Some
corporate rules may be the same in developed countries, but the actual way these rules are adopted and applied depend on legal details and informal rules that remain stable or change slowly. If disadvantages in terms of corporate governance mechanisms could be offset by competitive advantages in other domains market pressure would be not enough for structure harmonization.

THE DEBATE AND ITS LIMITS

Research yields unequivocal signs of convergence in terms of some principles or norms, or firms’ practices included in different corporate governance systems. That is what happens with inclusion of independent directors in the Board, the remuneration of managers, disclosure procedures, minorities’ activism, accounting harmonization, securities law and takeover regulation. Some authors tend to conclude that convergence with one system, or convergence with “best practice” (hybrid) systems, or functional convergence without significant formal harmonization, is going on. However, the same research shows the survival of important differences between systems, especially with respect to shareholder ownership (dispersion versus concentration), the control of agency costs, worker involvement in firms’ decision-making or voice, one tier or two-tier boards, the relevance of stock markets and markets for corporate control, and takeover practices. In accordance with this, other authors underline the persistence of each systemic identity and the actual incapacity of convergence or breakdown of existing institutional complementarities.

Which one of these two visions it is the more appropriate to evaluate the dynamics of the current process of institutional change? Following Miller (1997) in his words and not in the arguments, I would say “both” and “neither”. Both take advantage of some specific examples to support their arguments, but neither of them puts the debate in the
right terms, for one main reason. They are talking about different things when they refer to corporate governance. The thesis suggesting strong convergence uses the narrower conception of corporate governance, as the corporate institutional arrangement with which shareholders can prevent managers from diverting resources to other objectives than maximizing shareholder value (FAMA, 1980). It is a perspective confined to a small portion of rules and practices which can be perceived, in the confrontation among corporate governance systems as a kind of product or technology evolving towards the model that is the most efficient, utilizes best practices, and is best adjusted to market rules. In the long run, corporate governance policy enquiries would be irrelevant, because governance problems would take care of themselves (BRATTON and MCCAHERY, 2002).

Weakest theses about convergence usually see corporate governance from an intermediate viewpoint of institutional complexity, such as the rules of the game that govern corporations adopted by stakeholders, and how risks and incomes are shared between them (AOKI, 2006). The simplification and determinism involved in the above conception, whereby all firms face the same problems of optimization and seek the same solutions, are abandoned in favor of a relational view that assigns a specific function, embedded in national institutions, to the different systems of corporate governance. Here convergence may signify a tendency for hybridization in one of two ways. The optimistic consider that we tend towards models that draw advantage from the “best practices” of different systems adapted to local characteristics (KESTER, 1996). This means accepting that there are persistent differences among national institutions that are functionally equivalent but toned down by international competitive pressure. The less optimistic, evincing the troubles associated with changing formal
institutions, argue that firms will homogenize their practices to enhance competition against rivals but without formal convergence (COFFEE, 1999; GILSON, 2004).

Lastly, under an upper level of institutional complexity we have the other approaches facing corporate governance, such as a “nexus of institutions” (CIOFFI, 2000), that in each historical period and firm’s life cycle are essential for coordinating innovative investments and entrepreneurship (O’SULLIVAN, 2000; FILATOTCHEV and WRIGHT, 2005). These conceptions involve rules that govern the relationship between a corporation and its investors, stakeholders, and managers and the relationships among these players “including not only corporate law as conventionally defined but also securities law and the relevant parts of the law governing insolvency, labor relations, and financial institutions” (BEBCHUK and ROE, 2004). In these broader conceptions, persistence of corporate governance systems and national identities is usually preferred to convergence, because of path dependence, institutional complementarities and difficulties in dividing or transplanting components without damaging the competitive capacity of national economies. The same institutions transferred into different contexts do not automatically imply the same consequences in terms of the systems’ performance. Hybridization will be unstable and temporary (LANE, 203), because it is based on ruptures in the predominant institutional logic of each system and it cannot be sustained without the victory of one of the models.

CONCLUSION

In the last decade, corporate governance has attracted the attention of a large portion of literature and research relating to policy, theoretical and empirical analysis, and referenced to different countries and systems. However, although there is a standard dominant view of some important issues, the literature is not consensual about what
corporate governance means, because the breadth and systemic complexity of the institutions involved can be viewed from different perspectives.

This plurality of conceptions reflects methodological and theoretical options and, as we argued elsewhere (FORTUNATO, 2007), this is not free from important consequences. One of them concerns the objectives of the literature about corporate governance: contrary to the shareholder perspective and some versions of the stakeholder view, the other approaches are interested both in the institutional arrangements that sustain the individual remuneration of a firm’s input suppliers, and in other institutions that support innovation and entrepreneurship, with implications for corporate law, and for financial and labor market regulation.

Another important conclusion involves the theory of the firm implicit in different perspectives. While the shareholder perspective and the stakeholder view found their rationale in neoclassical economics theory, particularly its application to the theory of the firm based on the “nexus of contracts” (ALCHIAN, 1987), or on the “property rights” approaches (HART, 1995b), the organization control theory and the life-cycle theory assume a different framework, drawing on evolutionary and “resource-based” theories (FOSS et al, 1995).

A third important implication has been developed in this article and concerns the prognoses for convergence or the dynamics of institutional change. I have argued that the broader the conception of corporate governance used by the different perspectives, the less the enthusiasm for, and the sustainability of, the convergence hypothesis. Authors favoring the wider systemic conceptions of corporate governance are generally skeptical about the convergence hypothesis, because they foresee the obvious difficulties involved in breaking down the complementary institutional and national
specificities of various systems and some of them could be included in a residual stream well-known for its acceptance of notions like *path dependence* or local identity.
REFERENCES


