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DTI ECONOMICS PAPER NO.13

Corporate Governance, Human Resource Management and Firm Performance

PAPERS FROM A JOINT DTI/KING'S COLLEGE LONDON SEMINAR

AUGUST 2005

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Foreword

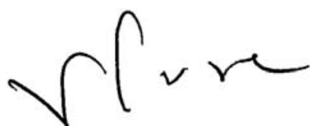
I am delighted to introduce this edition of the DTI Economic Research series. It makes an important contribution to the DTI evidence base. Governance is a broad term which encompasses internal structures and processes as well as external relationships between an organisation and its stakeholders. It therefore plays a key role in the functioning of the UK economy.

There have been significant developments in corporate governance in the UK, the US and other European countries over the last few years. To ensure that these changes have a positive impact on the performance of the UK economy we need to know more about the relationship between good governance and company performance.

The UK labour market has outperformed those of most other European countries. In addition the productivity gap between the UK and it competitors is beginning to close. People are a crucial input in the production process and their contribution will be affected by the governance framework they are operating in.

This volume offers a first step in linking these three topics. Good governance is essential to drive forward wealth creation in the UK by establishing an effective framework for corporate activity. It is therefore one component of many which lead to secure employment in the present and increasing employment in the future.

The first paper brings together existing research in the areas of corporate governance at the different stages of company growth. The second and third papers add the international dimension and shed additional light on the UK system by comparing it to the German and Japanese systems. The paper by Gospel adds the employee dimension by considering employee voice in the overall corporate government framework. The paper by Guest links this to company performance within the UK.



Vicky Pryce
Chief Economic Adviser and Director General, Economics. DTI

Introduction

The scandals at Enron, WorldCom, Parmalat and Global Crossing have placed the corporate governance systems of modern corporations under closer scrutiny than ever. Lapses in the personal and professional integrity of accounting firms and their corporate clients have undermined confidence in capital markets and led to substantial erosion of trust in the institutions of modern capitalism. As a result, investors and regulators are forcing companies to improve disclosure policies, to rethink their relationships with auditors and to strengthen corporate boards as part of a wide ranging reform of corporate governance. In addition, attention is increasingly focused on more recent debates around the appropriate balance between the exclusive pursuit of shareholder interests and the aims of other stakeholders as the main purpose of a firm. Managers are encouraged to measure and assess whether human resource management (HRM) practices, and indeed the HRM function itself, create or destroy shareholder value. However, there is little knowledge of the implications of value-maximising governance mechanisms for labour management.

Overall, there is a tendency in current academic and policy debates to leap to conclusions about what is wrong with corporate governance and internal management systems before understanding complex content and context factors associated with these issues. First, to find the true sources of weakness in modern systems of corporate governance, there is a need to take a longer-term view on the evolution of the firm's governance mechanism throughout its life-cycle: from the entrepreneurial stage of development through to maturity and decline. At present, the bulk of academic research and policy debates in the governance area are focused on large, mature firms that dominate the corporate landscape on both sides of the Atlantic. Relatively little is known about the roles and functions of corporate governance in young, fast-growing firms and Initial Public Offerings (IPOs). Similarly, the resource and service functions of corporate governance, although acknowledged in previous research, require further discussion and development.

Second, despite a growing number of theoretical and empirical studies, our understanding of complex and dynamic links between corporate governance configurations and organizational performance is still very limited. The strengths and weaknesses of different corporate governance models are not well documented empirically, and there is a very little agreement on what forms an "ideal" corporate governance template. Moreover, a growing body of literature on comparative governance has identified a number of similarities and differences in corporate governance structures and practices across countries. Anglo-American corporate governance remains a standard reference point or benchmark for comparing other countries. Likewise, changes in corporate governance are discussed largely as a process of international convergence. However, the diversity among corporate governance systems in the non-English speaking world is not very well understood.

Third, translating the desire to maximize shareholder value into management practice involves the application of financial techniques to assess the likely impact of any management decision on shareholder value, including decisions related to labour management and HRM. As a result, various links and complementarities have been posited between HRM and corporate governance. As a criterion of business rationality, shareholder value may run contrary to the participation rights and sharing of organizational rents. There is a growing concern among employment relations academics that the increasing popularity of the ideology of shareholder value as a guide to management action has coincided with major changes in HRM such as lack of participation and increase in job insecurity. However, the nature and long-term implications of these changes is not well understood.

This set of papers is one of the first attempts to draw attention to the various issues relating to the comparative corporate governance and labour management frameworks. It represents on-going work by some of the staff in the Department of Management at King's College London and builds on an earlier workshop for officials at the DTI and other government departments. By bringing together researchers working in the corporate governance and HRM fields, it aims to address the following theoretical and empirical questions:

- What do we know about the long-term evolution of the firm's corporate governance? Are there any differences in relationships between the firm's insiders, outside investors and other stakeholders at various stages of its life-cycle?
- What is the optimal balance between the monitoring and control, resource and service roles of the governance mechanism in different phases of the firm's development? What shifts are there, if any in this balance when the firm moves from one stage in its life to another?
- What are links between corporate governance configurations and organizational performance?
- What are the changes in the national and 'institutional patterns' of governance? How have changes in the role of capital markets impacted long-term employment and the stakeholder-oriented nature of corporate governance in countries such as Germany and Japan?
- What is known about links between human resource management and corporate performance?

The various papers examine these issues and develop an integrated picture of the links between governance and labour management. The first set of three chapters examines corporate governance life-cycle stages and governance configurations and impact in different national and institutional contexts. The second set of two chapters consider links between governance and HRM, as well as performance implications of different HRM practices.

Igor Filatotchev develops an integrated framework that links the firm's life-cycle with business strategy and the dynamics of corporate governance. He argues that, from a resource-based perspective, a firm's corporate governance system per se may not be a source of sustained competitive advantage but

some firms may be much more skilled at implementing common governance devices and these skills may be heterogeneously distributed across firms. Implementing the appropriate governance in a given situation may help firms to realize the benefits of the resources they control through incentivizing and/or monitoring management to undertake the relevant actions. Governance choices may impact on both the creation of rents from the use of valuable resources as well as their appropriation. This suggests that there may be important differences between the structure and functioning of a governance mechanism designed to minimise agency costs, and governance designed to maximise a firm's rent generating potential. The top management team and outside investors, therefore, have to find the right balance between the multiple functions that corporate governance may perform in the evolving firm. A right balance may form a source of sustained competitive advantage and support the firm's development and transition through its strategic thresholds.

However, governance factors may also create serious barriers to transition from one threshold to another, and this may contribute to our understanding of why so many firms fail to overcome their governance "thresholds". This framework provides insights for the development of corporate governance codes. There has been some debate about the relative importance of the wealth protection versus wealth creation aspects of corporate governance in attempts to develop corporate governance codes. This chapter suggests that the development of 'one size fits all' corporate governance codes may be highly problematical for firms at different thresholds in their life cycle.

Links between corporate governance and performance are the focus of Jenifer Piesse's chapter. This paper reviews recent empirical research that relates systems of governance with firm performance, based on three broad research questions: How do firms perform, given their internal model of governance, multiple stakeholders and external constraints? Is evidence of the importance of corporate governance influenced by the way performance is evaluated? Is 'good' governance an input into firm performance or simply a mechanism to minimise agency costs?

The chapter begins with an analysis of various performance measures used in previous corporate governance research, such as accounting ratios, stock-market performance, and various measures of productivity. Piesse argues that the particular choice of performance measurements may influence the research outcomes. In terms of the organisational effects of corporate governance, evidence on the relationship between firm performance and mechanisms to control agency problems or corporate responsibility is ambiguous. Piesse provides a comprehensive review of various studies in the finance, economics and management fields that considers these issues not only within the conventional UK/US environment but also internationally, including research on India, South Africa, Taiwan and elsewhere. These allow different aspects of governance research to be considered.

Piesse concludes that events that are either exogenous to the firm or result from the market perception that firm behaviour can readily be assessed by share price changes, although these may not provide appropriate responses due to the inability of the market to correctly predict outcomes. This can lead to results such as a sharp fall in price following poor safety practices, followed by an acquisition announcement that reverses the share price although not the livelihoods of those affected. Accounting ratios are less open to market sentiment and provide a more consistent estimate of firm performance. These studies are more reliable and allow characteristics of the board and family control to be captured with certainty. However, modelling firm behavioural decisions, either by econometric estimation or total factor productivity indices, with changes explained by governance variables results in a far richer set of results. But, regardless of the methods used, the construction of detailed and timely data is crucial for the results of social science research to be of value in the policy process.

The contribution by Gregory Jackson concerns the diversity of national corporate governance systems in the light of recent reforms around the world, focusing on Germany and Japan. An emerging literature suggests viewing corporate governance as a system comprised of interrelated elements having strategic or institutional complementarities. One institution may reinforce or have effects that are contingent upon the presence of other complementary institutions. The literature on complementarities makes an important contribution by suggesting that corporate governance should not be based on "one best way", but that diverse national models of corporate governance have different comparative institutional advantages. Complementarities thus stress that the relative efficiency of a governance practice depends on the surrounding institutional context. Meanwhile, corporate governance reform around the world is often informed by the principles underlying the U.S. or UK models of corporate governance – such as shareholder rights, transparency and disclosure, variable management compensation, and the use external independent directors. Consequently, corporate governance reform raises particular challenges for countries like Germany and Japan, which are attempting to adapt their models of stakeholder or bank-based corporate governance to a changing international environment.

Jackson outlines the similarities and differences between Germany and Japan in terms of governance configurations (e.g., ownership structure, board composition, etc.) and related national institutions. This analysis is followed by an in-depth discussion of selected areas of governance reforms: legal reform, the role of banks, and foreign investors. In particular, the author provides evidence of links between corporate governance reforms and the role of employees as corporate stakeholders, which provides a bridge between first three chapters and the remaining part of the book. More specifically, employees exercise voice within corporate governance through participating in company decisions, such as legal rights to codetermination in Germany or extensive use of joint labour-management consultation in Japan. However,

corporate governance reform and new pressures from institutional investors raise a question as to what extent stakeholder-oriented governance and high performance human resource management systems are compatible with this changing environment.

In both Germany and Japan, the core of stable employment has indeed become smaller through negotiated and incremental employment adjustment processes. In Germany, shareholder-value is associated with performance-based pay schemes linking salaries to business and/or individual performance. Although performance pay has not replaced existing pay schemes, it nonetheless represents a de facto decentralization of collective bargaining. In Japan, the lifetime employment system is basically stable, but the system of seniority-based pay is undergoing modifications and merit-based pay is being introduced. This chapter concludes with implications of the German and Japanese cases for issues of international convergence and public policy.

Howard Gospel brings together research on corporate governance and employee voice. His chapter draws on two streams of research. The first part deals with the provision of information to employees. This section is UK-based, micro-level, and focused on the workplace. It uses data from the 1998 UK Workplace Employee Relations Survey (WERS). The second part is concerned with how corporate governance may affect broad labour outcomes. This section is macro-level, internationally comparative across countries, and focused on broad national systems of corporate governance and labour relations. It uses data from international sources, such as the World Bank, Stock Exchange Yearbooks, and the Organisation for Economic Cooperation and Development (OECD). The author provides empirical evidence that suggests that the main effects of information disclosure are on labour productivity, rather than on quality, with the strongest positive effect on labour productivity being provision of information on performance targets, a more operational type of information. However, performance feedback only tends to have a positive effect on labour productivity where levels of employee organisational commitment are high. The author then moves on to the analysis of labour outcomes of various governance systems considered on a macro level. His empirical analysis suggests that market outsider governance systems are associated with shorter average job tenures, as firms are more likely to lay-off workers during downturns and as workers in turn look to the external market in upturns. Firms are also likely to make more use of contingent employment, such as temporary and part-time workers, who have fewer claims on the firm and who can be more easily laid off during bad times. In part as a result of these factors, less training may be done in such systems, especially since returns on investment in human capital are difficult to measure and not valued by financial markets. In terms of research implications, these findings would suggest that a move towards more flexible employment systems may be as much, if not more, driven by finance and governance factors than by other sets of explanations, such as product markets, government policy, and weakening industrial relations institutions. Countries wishing to move towards

more flexible labour arrangements might therefore do well to consider the promotion of more marketised finance and corporate governance. However, governments that seek to promote more Anglo-Saxon type finance and governance, but at the same time hope to maintain more coordinated and less marketised employment systems, will find it difficult to achieve both simultaneously.

Finally, David Guest provides a comprehensive summary of research on links between HRM practices and the firm's performance. He takes as his point of departure the report of the Kingsmill Working Group which advocated that as part of their governance, boards of companies should give greater attention to accounting for the management of their workforces. He goes on to explore the business case for doing so by outlining research on the relationship between a stronger adoption of progressive human resource practices and firm performance. The results presented in his paper consistently reveal an association between greater use of these practices and superior firm performance, reflected in indicators such as profit per employee. Further research is cited indicating that the adoption of such practices is also likely to be associated with lower labour turnover and higher employee satisfaction and well-being. In short, there is the potential in the adoption of these practices for gains by a range of stakeholders.

A second part of the paper reports only a modest adoption of such practices among UK firms and speculates on why this should be so. Interviews with a number of senior executives confirm that for a variety of reasons most do not believe it is necessary to give priority to improvements in human resource management. This appears to reinforce the recommendations of Kingsmill that organizations should be required to account for the governance of their workforce and to demonstrate that they do take seriously the management of their human capital.

Taken together, the papers in this collection highlight developments in the theory, methodology and findings of research on corporate governance and firm performance. They indicate that insights are to be gained from a range of disciplinary and methodological perspectives and from a combination of local and international comparative studies. Findings from the research highlight the importance of careful theory-building, of taking account of the different stakeholders interests in the effective management of corporate governance and of the need to consider a flexible range of potential performance outcomes of governance. There is also some evidence that the boards of a number of companies have yet to recognise the full implications of the demands for more effective corporate governance.

This volume suggests a number of important implications for academic research and practice. Although corporate governance and HRM debates have developed in their own, separate ways, a number of chapters clearly indicate that they are inter-linked. More specifically, there may be a relationship

between corporate governance and “high performance” HRM that emphasises the importance of fostering mutual commitment to common goals between managers and employees. Another related issue may be exploring the “new psychological contract” in the context of organisational change and flexibility.

Another important implication of this book’s analysis is that corporate governance is a configuration of many elements. Good corporate governance depends on complementarities with the international and national contexts, firm life cycles, and other strategy variables (including HRM). There are some theoretical models of these inter-relationships, but not a good empirical understanding. Part of the problem is that (linear) statistical models may not capture this notion of corporate governance mechanisms as configurations of firm-, industry and nation-level parameters.

In conclusion, this book represents a step towards the development of a dynamic model of corporate governance that may help to examine organizational outcomes of various governance and HRM practices. It also emphasizes the importance of an integrated framework of corporate governance and HRM including strategy, innovation and learning, and it can help to guide future studies focused on these important issues.

Igor Filatotchev
David Guest

1. Conference Session 1 The Firm's Life-cycle and the Dynamics of Corporate Governance: Overcoming Governance "Thresholds"

Igor Filatotchev
King's College London

1.1 Introduction

Corporate governance scandals and accounting failures such as Maxwell in the UK and Enron in the US have been dominating academic research and business debates during the last decade. An increasing number of financial and ethical problems are recognised as symptoms of failing governance and systems of accountability and control in publicly quoted firms. As a result, regulators and investment communities in many countries have already responded by seeking to improve corporate governance and accounting standards. Starting with the Cadbury Report in the UK (Cadbury, 1992) there has been an international diffusion of codes and recommendations (see Demirag et al., 2000, for a review). This geographical spread has not been restricted to countries with Anglo-American corporate governance systems.

Much of this attention has been focused on large nature companies, with samples typically based on the largest FTSE listed corporations in the UK and the Fortune 500 in the US. Many of these firms operate in relatively stable or 'low velocity' environments. From a theoretical point of view, much research effort has been under-pinned by an agency perspective (Hart, 1995). The principal-agent framework has had a profound impact on organization research in general, and corporate governance theory in particular (Dalton et al., 2003; Fama, 1980; Jensen, 1993). The central premise of this framework is that managers as agents of shareholders (principals) can engage in self-serving behaviour that may be inconsistent with shareholders' wealth maximization principle. To constrain managerial opportunism, shareholders may use a diverse range of corporate governance mechanisms, including monitoring by boards of directors and mutual monitoring by managers (e.g., Fama and Jensen, 1983; Rediker and Seth, 1995) as well as monitoring by large outside shareholders (e.g., Demsetz and Lehn, 1985; Holderness and Sheehan, 1988). In addition, internal governance mechanisms may include various equity-based

managerial incentives that align interest of agents and principals (Jensen and Murphy, 1990; Murphy, 1985). Finally, the external factors, such as the threat of takeover (e.g., Grossman and Hart, 1988; Shleifer and Vishny, 1997), and competition on the product (Hart, 1983; Jensen, 1993) and managerial labor markets (Fama, 1980) may constrain managerial opportunism. Rediker and Seth (1995) suggest that a combination (or *bundles*) of internal and external governance mechanisms may reduce principal-agent costs and align interests of principals and agents.

Within this theoretical framework, emphasis has been placed on the monitoring and control dimensions of governance. Indeed the Cadbury Report's terms of reference were specifically restricted to financial or accountability aspects. Both policy and research attention has thus been focused on the roles of non-executive directors and the functioning of boards, disclosure practices, companies relationships with auditors, executive remuneration issues and the roles of institutional investors (Short et al., 1999).

These developments, however, have given rise to an overly narrow perspective on corporate governance. Corporate governance is both about ensuring accountability of management in order to minimize downside risks to shareholders and about enabling management to exercise enterprise in order to enable shareholders to benefit from the upside potential of firms (Keasey and Wright, 1993; Tricker, 1984). This distinction has sometimes been referred to as the wealth-creating and wealth-protecting aspects of corporate governance. Therefore, there is a need to extend our understanding of governance issues beyond the narrow confines of economics and finance perspectives to embrace both strategy and knowledge dimensions as well as contextual issues.

This paper extends previous research and makes a number of contributions. First, it develops a novel conceptual framework that integrates strategic dynamics of the firm with changes in its governance systems. It rejects the notion of a universal governance template and argues that corporate governance parameters may be linked to strategic "thresholds" in the firm's life-cycle. Second, the paper extends agency research by suggesting that other roles of corporate governance, such as resource and strategy functions, may have importance alongside its monitoring and control functions. Third, it links the firm's strategic thresholds with changes in balance between governance functions. More specifically, it argues that changes in firm's strategic positioning may be associated with re-balancing between wealth-protection and wealth-creation functions of governance. In recognizing these points this study moves the analysis on by examining how corporate governance may help the firm to overcome its strategic thresholds, as well as create significant barriers to its development.

1.2 The firm's life-cycle and the dynamics of corporate governance

Traditionally, corporate governance studies are based on various conceptual frameworks that have been developed by financial economists and researchers in the field of corporate finance (see Hart, 1995, for a review). In recent years researchers working in other areas of economics and management have also provided an important contribution to governance debates. Strategy research, for example, increasingly recognises that corporate governance is an important organizational factor that affects the firm's performance and long-term survival. From a resource-based perspective, a firm's corporate governance system *per se* may not be a source of sustained competitive advantage but some firms may be much more skilled at implementing common governance devices and these skills may be heterogeneously distributed across firms. Implementing the correct governance in a given situation may help firms to realize the benefits of the resources they control through incentivizing and/or monitoring management to undertake the relevant actions. Governance choices may impact both the creation of rents from the use of valuable, rare, costly to imitate, and non-substitutable resources as well as their appropriation (Coff, 1999). Managers may be able to appropriate a disproportionate share of the rents a firm generates from an agency perspective. On the other hand, adequate compensation for their firm-specific investments may serve to reduce agency conflicts and be in the interests of equity holders (Castanias and Helfat, 2001). Similarly, boards may be more effective where they involve the recruitment of skilled directors who can help a firm fully realise its potential for generating economic rents rather than the appointment of the CEO's cronies or of outsiders focused on minimising agency conflicts between a firm and its equity holders. This suggests that there may be important differences between the structure and functioning of a board designed to minimise agency costs, and a board designed to maximise a firm's rent generating potential (Barney et al., 2001).

Although corporate governance studies have typically been focused on large firms with diffuse ownership, they are also important for younger founder managed firms, particularly for those reaching a point in their development when they begin to face constraints on their ability to realise growth opportunities. The agency based corporate governance lens may be applied to these threshold firms since it is at this point that issues arise surrounding the pressures on founders to cede control if their firms are to grow. Yet, at the same time these firms need to find the resources and knowledge to enable them to grow.

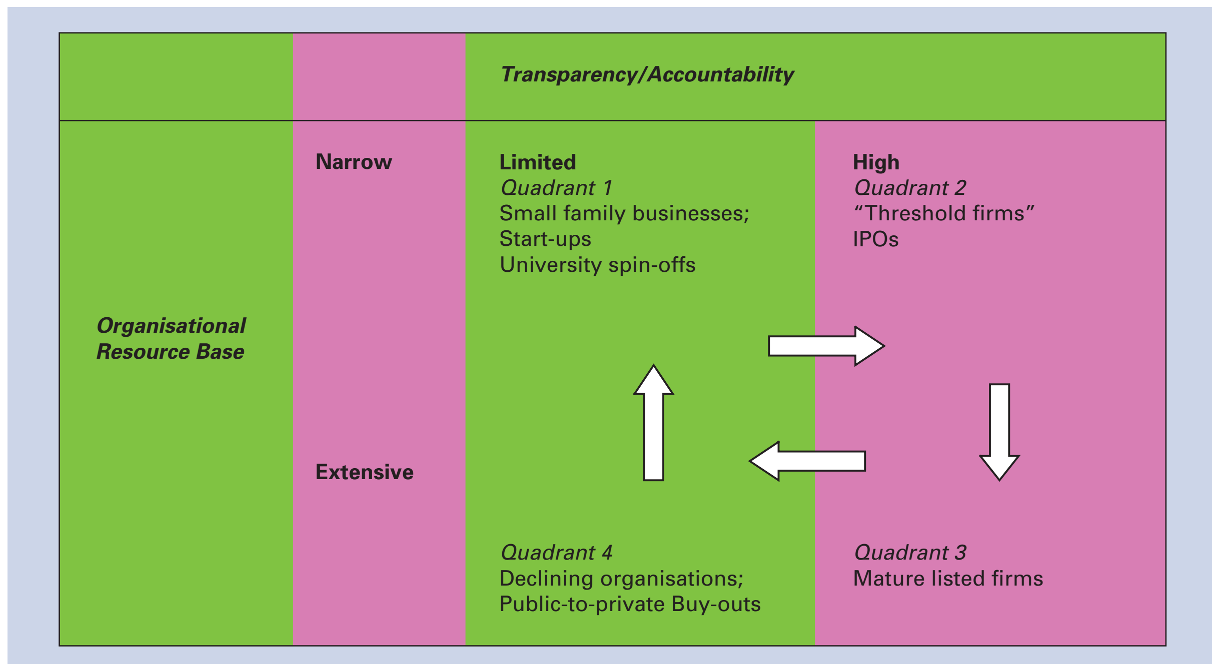
In addition to corporate finance studies, behaviour and knowledge perspectives started having a strong impact on governance research. Gedajlovic et al., (2004) extend an agency perspective on governance to suggest that the particular blend of incentives, authority relations and norms of legitimacy in founder firms interacts with the external environment to affect

the nature and pace of learning and capability development. Founder-manager governance becomes less adept at dealing with the environments that become more munificent, complex and stable as firms develop. They suggest that governance needs to change first to overcome these problems as a prerequisite for dealing with the need to change a firm's resources, processes, values and culture. In contrast, Zahra and Filatotchev (2004) suggest that a knowledge-based view offers a more realistic and dynamic insight into the relationships that pervade threshold firms' governance systems. At the threshold stage, the resource and knowledge roles of governance may be particularly important for increasing strategic flexibility and ensuring long-term growth and survival. When the entrepreneurial firm matures and its management becomes more professionalised, changes in its ownership structure and the growing importance of external stakeholders may shift the balance towards the monitoring and control functions of governance systems, as suggested by agency research. Zahra and Filatotchev argue that corporate governance systems and organizational learning are interdependent, and in some cases may substitute or complement each other. A knowledge-based analysis of governance recognizes the importance of strategic context and the relevance of different types of knowledge at different stages of the firm's life cycle.

This debate suggests the notion of a number of firm life-cycle stages where there may need to be different forms of corporate governance. Corporate governance may thus need to be viewed as a dynamic system that may change as firms evolve over these stages. The firm's evolution is accompanied by changes in ownership structure, board composition, the degree of founder involvement, etc. The balance of the accountability and enterprise roles of the various governance elements may change over this life-cycle from establishment, growth, maturity and decline. For example, the knowledge contribution of boards may be more important in growing entrepreneurial firms than in firms facing more mature markets.

These arguments suggest that the firm's strategic dynamics and corporate governance changes are inter-linked, and the firm's life-cycle may go hand-in-hand with dramatic shifts in its governance system. Figure 1.1 provides a summary of this complex, time-dependent inter-relationship, best envisaged as two interacting continua with the extreme cases of narrow and extensive organisational resource base at either end of the vertical axis and of high and limited accountability of managers to external shareholders at either end of the horizontal.

Figure 1.1
Organizational and corporate governance dynamics



Source: Filatotchev, I. and Wright, M. (eds), *Corporate Governance Life-cycle,* Cheltenham: Edward Elgar, 2005.

As this figure shows, changes in organisational development stages are accompanied by different combinations of resource diversity and accountability, and these combinations define the strategic positioning of an individual firm with respect to its environment. In the early stages of the life-cycle (Quadrant 1), the entrepreneurial firm has a narrow resource base. It is, as a rule, owned and controlled by a tightly knit group of founder-managers and/or family investors, and the level of managerial accountability to external shareholders is rather low.

However, as the firm grows following its market expansion strategy and new opportunities, its governance system begins to change. In order to access external resources and expertise that may fuel and support this growth, the firm opens up its governance system to emerging external investors, such as "business angels" and venture capital firms. At this stage, the balance between resources and accountability starts to shift towards greater transparency and increasing monitoring and control by these emerging external providers of resources. An Initial Public Offering or IPO (Quadrant 2) represents a dramatic shift from an entrepreneurial firm to a "professional" firm with a fully developed governance system. This shift in accountability widens the firm's access to the vast pool of financial resources of the stock-market. This stage is followed by an expansion of the firm's resources base as it matures and exploits strategic opportunities (Quadrant 3).

Quadrant 4 represents a final stage in our resource-governance cycle. At this stage, the firm may have exhausted its growth opportunities in the focal industry and over-diversified into related and unrelated industries (Hitt et al.,

2003). As a result, its governance system may have become less transparent, and incentive alignment between managers and external shareholders more loose. Managerial drive for ever-increasing expansion and diversification leads to performance deterioration and loss in shareholder value. Despite a substantial inherited resource base, an opaque and inefficient governance system cannot prevent managerial opportunism or arrest organisational decline (Filatotchev and Toms, 2003). In a turnaround situation, governance itself may turn into a driver of further decline by imposing serious financial constraints on the organisation that erode its resource base (Toms and Filatotchev, 2005). The only viable strategic alternative at this stage may be to take a public company private. In terms of Figure 1.1, this would complete the firm's governance life-cycle. Restructuring of a declining organisation or following a public to private buy-out may result in a reinvigoration of the life cycle as more transparent incentive and governance mechanisms are introduced in the form of increased managerial equity, monitoring by private equity firms and a commitment to service debt (Jensen, 1993; Thompson and Wright, 1995). As such, the organisation may narrow the scope of its activities and move back towards the other quadrants.

By focusing on resource-accountability issues, this framework may be a useful heuristic lens to analyse various content and context aspects of the corporate governance life-cycle. First, it may help to understand factors that affect the balance between the possible functions of corporate governance. Agency research is predominantly focused on the monitoring and control functions of corporate governance mechanism. The resource dependence and strategic change perspectives have suggested that, in addition to control functions, corporate governance factors may also play service/resource and strategic roles in the decision-making process (Pfeffer, 1972; Zahra and Pearce, 1989), especially when the firm is in a crucial transition phase such as the IPO (Daily and Dalton, 1992). For example, the links that independent directors have with the firm's environment can be used to obtain the financial resources needed for growth, as well as important information and strategic expertise (Golden and Zajac, 2001). Institutional investors involved in a focal firm also may be an important support mechanism by providing access to financial resources when needed (Filatotchev and Toms, 2003).

Figure 1.1 informs our understanding of governance dynamics and the changing roles of governance factors when the firm evolves along its life-cycle. At early stages of its life-cycle, the firm finds itself in a 'high velocity' environment where it has to move fast to secure its competitive advantages and build strategic flexibilities. Firms that are developing along founder/IPO and IPO/maturity threshold often find themselves operating in this type of strategic environment. When the firm overcomes these first strategic threshold associated with the liability of smallness and newness, it matures and moves into a 'low velocity' environment. Firms evolving through their maturity/decline and 're-invention' thresholds would be operating in this strategic environment. At these stages of their life-cycle they have developed a substantial resource

base, very often by growing through M&A and extensive diversification. At the same time, stable rents may lead to the 'strategic rigidity' and inertia. Over diversification strategy pursued by managers of mature firms can also lead to value destruction and strategic decline. To reverse these dangerous trends, the firm very often has to 're-invent' itself through re-focusing and strategic restructuring, that involves financial (e.g., share buy-backs, buy-outs of parts or the whole business, etc.) and organizational (e.g., downsizing, retrenchment, etc.) strategies.

This discussion also differentiates between value-creation and value-protection roles of corporate governance. Combined with the strategic environment factors, this framework helps to understand the process of re-balancing between different functions of corporate governance.

At founder/IPO "threshold" stage of the firm's evolution, resource and knowledge roles of governance may be particularly important for increasing strategic flexibility and ensuring a long-term focus on growth and survival. Certo et al. (2001) suggest that in young and rapidly expanding organizations agency problem and control-related benefits of independent boards are not as prevalent as compared to mature or declining firms. In this context environment, emphasis should be made on value-creation functions of corporate governance, and, therefore, on the resource and service roles of governance. For example, the process of creating experienced and knowledgeable boards that are able to support entrepreneurs may influence the firm's later competitive position. To the extent that the board's collective knowledge and experience can contribute to the firm's competitive advantage, "threshold" firms should pay early attention to who serves on the board (Finkle, 1998: 23). As a result, at this strategic threshold, monitoring role should be low, whereas resource and strategy roles should be high.

When the entrepreneurial firm matures and its management becomes more "professionalized" and moves towards maturity stage, changes in its ownership structure and the growing importance of external stakeholders may shift the balance towards the monitoring and control functions of governance systems, as suggested by agency research. At this stage, the value-protecting role of corporate governance becomes particularly astute. The stockmarket flotation and growth also helped the firm to develop its financial and non-financial resources, and resource role of corporate governance diminishes in importance. However, the high velocity environment creates numerous avenues for growth, and strategic advice remains to be an important function of corporate governance.

When the firm enters the stages of maturity and decline, the monitoring role of corporate governance once again may become important (Toms and Filatotchev, 2004). As Jensen (1986; 1993) in his analysis of the agency aspects of free cash flow (FCF) strongly points out that agency conflicts are especially severe when the organization matures and generates substantial rents. FCF

hypothesis predicts that managers with unused borrowing power and large cash reserves are more likely to undertake low-benefit or even value-destroying mergers or unrelated diversification programs (Chatterjee and Wernerfelt, 1991; Lang and Litzenberger, 1989; Lehn and Poulson, 1989). Although existence of free cash flow alone does not imply agency costs, the FCF hypothesis assumes that it can increase managerial entrenchment and encourage their self-serving behavior (Gibbs, 1993). Corporate boards, therefore, should be particularly vigilant in terms of their monitoring of managerial decisions in declining firms. At the same time, in this context environment, resource and strategy roles of corporate governance become less important.

When the declining firm is making an effort to re-invent itself and overcome effects of decline, this strategic threshold may again change the balance between various roles of its corporate governance system. Resource and strategy roles increase in importance as the organization attempts to reposition itself and seek new value creation opportunities. The monitoring role is less significant as declining organizations tend to have less FCF-related agency problems. Tight monitoring may be problematical as it constrains the flexibility that the firm requires to reinvent itself. Innovative activity typically involves high risk, unpredictability and long time horizons (Holmstrom, 1989). Bureaucratic mechanisms aimed at ensuring performance in large complex organizations may restrict experimentation and constrain innovative activity (Francis and Smith, 1995). A management buy-out with financial backing from private equity firms with both financial and market-related expertise and moderate amounts of leverage can introduce the flexibility needed to re-invent the company (Wright et al., 2000; 2001). There remains a need for some monitoring to ensure that management do not become entrenched or otherwise behave in a way that is detrimental to the interests of funds providers. This is in contrast to the classic leveraged buy-out involving high amounts of debt and close financial monitoring by a leveraged buy-out association that typically severely restricts management discretion (Jensen, 1986).

The top management team and outside investors, therefore, have to find the right balance between the multiple functions that corporate governance may perform in the evolving firm. A right balance may form a source of sustained competitive advantage and support the firm’s development and transition through its strategic thresholds. However, it follows from our theoretical framework that governance factors may also create serious barriers to transition from one threshold to another, and this may contribute to our understanding of why so many firms fail to overcome their governance “thresholds”.

The research framework presented in Figure 1.1 may be also extended beyond the simple emphasis on firm-level aspects and mechanisms to encompass more general industrial and institutional changes in a particular country.

Deregulation, for example, may impact both the resource base and governance characteristics of firms such as in the utilities and transport sectors in many countries, and define a new phase in their life-cycle. Similarly, institutional changes such as the development of a market for corporate control, may change the extent of managerial accountability even if other, firm-level, governance factors do not change. This framework suggests that the firm's strategy and governance life-cycles should not be analysed separately from economic and institutional dynamics in a particular country.

1.3 Transition between life-cycle stages: overcoming governance "thresholds"

There is a considerable volume of research that explore governance characteristics of firms at different stages of their life-cycle. Daily and Dalton (1992) have focused attention on the professionalisation problems faced by the emerging founder managed firm, this is not the only threshold in the life-cycle of the firm. Each transition between the stages of a firm's life-cycle may be conceived as representing a threshold that needs to be surmounted. A key issue faced by firms concerns how they pass through the threshold from one stage in their life-cycle to the next and how corporate governance mechanisms adapt to facilitate or hinder this process.

An important aspect of this issue concerns the extent to firms are able to adapt their governance mechanisms in a very flexible manner or whether there is significant path dependency. An interesting approach is adopted by Lynall et al. (2003) who consider agency, resource dependence, institutional, and social network theories to show how board composition and, consequently, firm performance are a reflection of both the firm's life cycle stage and the relative power of the CEO and external financiers at the time of founding. They argue that boards are subject to path dependency, and, thus, board composition is likely to persist over time.

Entrepreneurship and Venture Capital (VC) research is focused on governance problems in young, fast-growing firms (Quadrant 1 in Figure 1.1). High tech ventures being spun-off from universities provide interesting examples of very early stage thresholds faced by new ventures. Vohora et al. (2004) identify four critical junctures in the development of these spin-outs: opportunity recognition, entrepreneurial commitment, credibility to customers and financiers, and sustainability. The nature of governance may need to change quite significantly over these stages of development to enable the venture to overcome the critical junctures. Ucbasaran et al (2003) have shown that an important part of the development process of a venture is the entry and exit of team members. In spin-outs from universities, the initial opportunity recognition and entrepreneurial commitment phases may require the academic entrepreneur to be supplemented by an external, surrogate entrepreneur with the requisite commercial and industrial skills (Franklin et al., 2001). At the later credibility and sustainability phases, there may be a need for more formal

governance mechanisms with the entry of non-executive directors, commercial managers, external investors, etc. Academic and surrogate entrepreneurs, university technology transfer officers and post-doctoral students may exit the venture at the entrepreneurial commitment, credibility and sustainability phases owing to conflicts regarding the future direction of the venture (especially as ventures typically require reorientation as the feasible route to market becomes clearer) or because their skills cease to be valuable. These entries and exits raise important governance issues in terms of how changes in the equity holdings are negotiated, the selection of new equity holders and the replacement of existing equity holders. To what extent are these changes being resolved by the power that comes from the size of an individual's equity holding or to what extent and when do other governance mechanisms become more important? Further research is required that examines the process by which these changes are facilitated.

As environmental and organizational complexities grow, different knowledge and skills are needed to effectively manage the entrepreneurial and administrative challenges, and the founder's knowledge that has been accumulated in the past, may create a cognitive barrier to effective strategic responses to changing circumstances (Daily and Dalton, 1992). This situation presents a threshold for early stage firms. To cross this threshold these firms need to cede control to professional managers. Zahra and Hayton (2005) shed light on this issue by examining how board composition varies from the start-up (years 1 through 5) to the adolescent stage (years 6-8) of the organisational life cycle and how board composition influences the innovative and financial performance of high technology new ventures. Innovation enables new ventures to position their products differently from the competition and achieve profits that reward entrepreneurs for their willingness to take risks. They apply organisational life cycle and resource dependence theories in examining 416 U.S. high technology new ventures and find significant shifts occur in board composition as new ventures move from the start-up to the adolescent stage. Changes in board composition reflect the strategic challenges and contingencies new ventures face in their operations. Different board composition variables influence the innovative and financial performance of new ventures differently in the start-up vs. adolescent stages. The representation of outside directors on the board increases significantly as firms mature and boards in adolescent firms show greater diversity in their educational and functional backgrounds than those that govern start-up firms.

The succession process in family owned firms highlights important governance issues. Several studies have examined the mechanisms and structures that can be utilized by family firm owners seeking to transfer family firm ownership and management control to the next generation of family members. This is an important issue as only about one-quarter of family businesses are estimated naturally to possess the blend of skills and capabilities needed to transfer their business to the next generation. Many of the factors impeding the transfer of family firms to the next generation are

influenced by the complex intertwining of family, ownership and management systems which exists in family firms. There may be irreconcilable family differences between owners of family firms, and an internal transfer of ownership within the dominant family group owning the business cannot be achieved. For example, using an agency-theoretic lens and insights drawn from the behavioural economics and family business literatures, Schulze et al., (2001) develop hypotheses concerning the effect of dispersion of ownership on the use of debt by private family-owned and family-managed firms. From a field study of 1,464 family firms they find that, during periods of market growth, the relationship between the use of debt and the dispersion of ownership among directors at family firms can be graphed as a U-shaped curve. They argue that just as the separation of ownership and control in widely held firms drives a wedge between the interests of principal and agent, the dispersion of ownership in family-held firms drives a wedge between the interests of those who lead a firm and other family owners. Their arguments suggest that, contrary to the tenets of conventional agency research, inside ownership and board oversight do not efficiently resolve the problems experienced by private, family-owned and managed firms.

A growing number of studies is focused on governance impact of venture capital (VC) baking on an investee firm. Mayer (2005), for example, examines the role of VCs and changes in corporate governance over the different stages of venture growth. This involves a transition from personal to business angel to venture capital to stock market finance and a gradual broadening of the investor base. Control moves from the entrepreneur to single outside investors who are active managers, to financial institutions who use intermediary venture capital firms to screen and manage their investments, to stock markets with largely passive investors. As such, VC is just one stage in a gradual transition from tight ownership and control by founders and families to widely held shareholdings. The VC helps bridge that transition by providing intermediation between investors and firms. As such, it is an institutional form for which there will be an enduring need. The notion of venture capital may vary between institutional environments. A VC firm performs a fundamental intermediary role in the UK and US that few other institutions undertake. While there may be a continuing need for VC type institutions within the context of Anglo-American market economies, their function and significance may endure in other forms elsewhere. For example, in many countries the VC firm is little more than a subsidiary form that allows a bank to invest in higher risk activities. Mayer (2005) suggests that there is no single best form of high tech financing and the most important function that regulation can perform is to encourage institutional experimentation and innovation.

Considerable attention has been focused on the principal agent problem between VC and entrepreneurs. VC-backed firms may in fact suffer from two sets of agency costs which are related to principal-agent and principal-principal relationships between the founders and members of the VC syndicate. As a result, new governance arrangements may need to be introduced to mitigate

the agency costs associated with VC involvement in fast-growing firms. Filatotchev et al. (2005), for example, examine the development of effective boards in venture capital (VC)-backed initial public offerings (IPOs). Using a unique sample of 293 entrepreneurial IPOs in the UK they show that VC syndicates invest in relatively more risky firms. VC-backed IPOs have more independent boards than IPOs with no VC involvement, with board independence being higher in syndicated VC-backed firms. They also find that single VCs team up with industry partners, whereas in syndicated IPOs there is a higher equity presence of passive private equity firms investing alongside VC firms.

As Figure 1.1 suggests, a public flotation represents the first major shift in the firm's life-cycle (quadrant 2). Although expanding, the resource base of the firm is still relatively narrow, but emergent external investors demand an increase in managerial accountability in exchange for their support. This transitory stage of the firm's life-cycle development is often equated with the "re-birth" or "re-start" of organisations (Finkle, 1998: 6). Daily and Dalton (1992: 25-26) indicate that at this threshold stage the firm is "at (or near) the point of transition from entrepreneurial to professional management. This transition appears to be inevitable as the firm outgrows the expertise and resources of the entrepreneur-founder". In moving from private to public ownership, IPO firms offer their stock to the public market for the first time. The associated transition from "entrepreneurial" to "professional" management (Daily and Dalton, 1992) requires a substantial effort, particularly on the part of the company's top management team, existing investors and advisors, to prepare the IPO firm for the scrutiny of the regulator and investment community and, more specifically, to establish a corporate governance system that will comply with the regulator's guidelines, such as the UK Listing Authority's Combined Code on Corporate Governance. Despite its growing importance for both academic and business communities, the process of corporate governance development in these threshold firms is not well understood. More specifically, very little is known about the factors affecting particular governance characteristics of this type of firms, such as the selection and incentives of non-executive directors (Daily and Dalton, 1992).

Previous research on the corporate governance problems of IPOs has increasingly drawn on agency theory (e.g., Beatty and Zajac, 1994) and upper echelon research (e.g., Filatotchev and Bishop, 2002) to generate a body of conceptual and empirical studies that are focused on various organisational outcomes associated with board structural characteristics and the allocation of ownership and control rights after the issue. Some authors have emphasised the governance role of large external shareholders in general and venture capital firms in particular (e.g., Megginson and Weiss, 1991;) in restraining the self-serving behavior of decision-makers in the IPO firm. This research, however, does not provide the answer to a related and equally important question– what factors determine *ex ante* board selection and ownership structure of the IPO firm in the first place?

A growing number of studies in the strategy area (e.g., Beatty and Zajac, 1994) and entrepreneurship research (e.g., Daily and Dalton, 1992) strongly point out that, in the context of IPOs, the governance system may be an endogenous mechanism that is closely related to the IPO founder team's (TMT) characteristics and distribution of power within the organisation (Filatotchev and Bishop, 2002). Being at an early stage of the firm's corporate governance life-cycle, the IPO provides a unique context for the analysis of the board development process. More specifically, IPO research may help to shed light on a number of relatively under-researched issues that Pettigrew (1992: 176) raised in his study on managerial elites, such as: Why do boards look the way they do? How are particular constellations of human resource assets on the board defined and built up? How does TMT power affect the control relationships between team members and the board? These questions, however, extend discussion beyond the relatively narrow boundaries of agency theory; and a growing number of studies suggest that agency framework should be used in conjunction with complementary theories in examining governance-related issues, including behavioural and socio-cognitive research.

The author's analysis of IPOs that floated on the London Stock Exchange (LSE) and the Alternative Investment Market (AIM) from January 1 1999 to December 31 2002 provides unique information on IPO governance characteristics and contrasts them with more mature firms. Table 1.1 provides comparisons between IPO firms and their more mature counterparts from the FTSE200 Index.

Table 1.1:
Firm-level and governance characteristics of IPO and FTSE 200 firms

	Entrepreneurial IPOs	FTSE 200[1]
	Firm-level characteristics	
Age (years since foundation)	6.7	n/a
Market capitalization, £ millions	106.8	3,657
	Corporate governance characteristics	
Non-executive Chairman	83.9	46
Non-executive directorships[2]	9.5	1.27
Executive shareholding[3]	32.1	1.83
Non-executive shareholding[3]	6.4	1.1
Venture capital shareholding[3]	9.7	n/a
CEO external directorships	5.5	0.67
Executives' external directorships[4]	10.0	0.81

Notes:
1. *Sources:* O'Sullivan (2000); the author's calculations.
2. Average number of outside directorships held by a non-executive director.
3. The percentage of the firm's total number of shares.
4. Average number of past and present external directorships.

As Table 1.1 shows, Board members in IPO firms had, as a rule, a relatively high number of outside directorships, which given their relatively narrow resource base, supports the relationships about knowledge resources and their application in Figure 1.1. In particular, IPO firms on average have a higher incidence of the separation of the positions of chairman and chief executive

officer (CEO) (83.9 % as opposed to 56% in the rest of the sample), and, on average 44% of the directors are non-executives. For example, a non-executive director in an IPO firm has 9.5 other directorships on average compared to 1.27 in the FTSE 200 firms. Their CEOs are also linked to a number of outside firms through the web of interlocking directorships which is much more “dense” then external “interlocks” of CEOs in the largest companies (5.5 and 0.67 external directorships respectively). Previous research identifies board interlocks with the firm’s capacity to access external resources (Filatotchev and Toms, 2003). The much lower figures for mature firms suggest that the resource role is less important and in the absence of ownership incentives, the monitoring problem is greater.

When a growing organization encounters rapidly changing environmental conditions, its board of directors may provide a particularly important strategic contribution through direct involvement in formulating the firm’s mission and developing its strategy. Some research (Hambrick and Jackson, 2002) links directors’ involvement in strategy development and implementation with their personal financial risk, approximated by ownership interests in the firm. As the firm reaches maturity and greater environmental stability, this role is reduced.

In summary, as the threshold is crossed the strategic role diminishes, and the emphasis shifts away from resources and towards monitoring. In terms of ownership structure, Table 1.1 clearly shows that IPO firms have a relatively higher concentration of ownership in the hands of executive and non-executive directors, which is a clear indication that fast growing firms are trying to create ownership-based incentive systems for their board members. The monitoring problem is thereby more easily attenuated in IPO companies through incentives relative to more mature companies.

Espenlaub et al. (2005) take a step further along the firm’s governance life-cycle and explore possible governance effects of lock-in arrangements after the IPO. These agreements form an important contractual context that defines ownership structure during the first few months after flotation since they require that (some) pre-IPO shareholders refrain from selling some or all of the shares they retained at the IPO during a certain, pre-specified period. Using a sample of IPOs issued in the UK during 1992-98, they investigate whether venture-capital (VC) backing of the IPO, and the existence, types and characteristics of agreements used by VC backers to lock-in their retained shareholdings, has any systematic association with the corresponding features of the lock-in agreements of company directors and other pre-IPO shareholders. The authors argue that lock-in arrangements serve a number of governance functions that may not be solved by traditional governance arrangements such as board characteristics and other control systems. These functions may be related to such issues as the information asymmetry associated with a fast-growing firm or the need to retain key managerial talent. The chapter’s analysis sheds light on the question whether the presence of VC backing, and the lock-in agreements of VCs act as strategic complements or

substitutes to the lock-in agreements of the directors and other shareholders. The authors also document the retained post-IPO share ownership of directors, VCs and other shareholders, and examine the associations between retained ownership, on the one hand, and the presence of VC backing and the existence and contractual characteristics of the lock-in agreements of VCs, directors and other shareholders, on the other.

Considerable research attention has been devoted to the role of corporate governance in mature firms (Quadrant 3 in Figure 1.1). Johnson (1996) reviewed studies that examine corporate refocusing, while a number of studies focusing specifically on the determinants of divestment have identified the role of corporate governance factors (Hoskisson, et al., 1994; Haynes, et al., 2000, 2003). However, attention to the role of incentives for managers in this work has been problematical. Murphy (1997) suggests that conventional size-based remuneration and non-pecuniary benefits of executive employment would tend to generate an incentive to build and maintain corporate empires. If the modern economy requires large firms to divest non-core activities, as Jensen (1993) and others have argued, the shareholder-principals need to provide alternative incentives. These are most obviously supplied in the form of share-based compensation. Haynes et al. (2005) extend previous work on the determinants of divestment in mature firms. Their research presents the first attempt to test for the importance of share-based incentives in motivating managers to take non-preferred downsizing decisions. Agency theory suggests that options are a cost-effective form of providing high-powered incentives (Sadler, 1999). They construct a series of share-based measures aimed at combining the incentive effects of actual share ownership with the wealth-augmenting effect of share price appreciation on the stock of options held by executives. Using a sample of 158 of the top 500 listed firms in the UK, they show that share-based incentives are indeed associated with divestment activity over the period 1985-1993 and suggest they might be necessary to persuade managers to take downsizing decisions that might otherwise harm their pecuniary and non-pecuniary well-being.

At the opposite end of the spectrum of the firm’s life-cycle stages is the situation of organisational decline (Figure 1.1, quadrant 4), and an important issue is related to governance transitions from maturity to decline. Research on business strategies in crisis situations has grown considerably in recent years, and a number of studies suggest that governance factors will interact with other firm's strategic characteristics to enable or constrain effective managerial response in crisis situations. These relationships are encapsulated in the notion of the organisation’s *strategic flexibility* defined as a firm's ability to respond to various demands from dynamic competitive environments. As acknowledged in a number of previous studies, when managers fail to respond to the adverse effects of rapid economic and social change and an actual or anticipated resource depletion, effective corporate governance can significantly influence organisational capacity to change in terms of managerial ability and willingness to undertake restructuring (Hoskisson et al., 1994; Zahra and

Pearce, 1989) While the general literature on strategic restructuring has accommodated this paradigm and achieved significant results, the effects of corporate governance mechanisms on managerial decisions and firm survival in an environment of industrial decline are relatively under-researched.

Toms and Filatotchev (2005) develop a theoretical model of strategic corporate turnaround integrating governance and associated financial arrangements. Their model suggests that in certain conditions retrenchment may be prevented by hard financial constraints. While some turnaround researchers suggest that retrenchment strategies involving the sale of critical assets might be detrimental as a result of trading short run survival for longer run strategic advantage, the model presented by Toms and Filatotchev suggests a more complex story. First, retrenchment is an integral part of the turnaround process according to a rational decision making model with financial and governance constraints. The supporting empirical case of the cotton textile industry confirms retrenchment to be a necessary condition for subsequent turnaround. Second, they show that asset sales are not always discretionary and the governance arrangements may prevent such disposals.

In another study, Toms and Filatotchev (2004) use institutional theory and argue that a firm's governance dynamics lags behind its strategic development, and this lag is defined, among other factors, by the institutional constraints and membership in various networks. These authors show that governance factors may constrain the firm's strategic flexibility, in particular in a business turnaround situation. More specifically, these authors investigated cliques of interlocking directorships that controlled much of the textile industry. This control remained a crucial feature of the industry in its decline phase. A survey using annual returns of textile companies in the 1950s has revealed interlocking directorships and a rump of residual small private shareholders (Filatochev and Toms, 2002). Table 1.2 shows that the typical director of a textile company in Lancashire sat on the boards of far more other companies in comparison to national averages. The average director of the typical large British company in 1950 held just that one board position. In contrast the Lancashire director held three or four board positions with a significant minority holding more than six. The most common type of interlock was in other cotton industry companies. The average age of each director in the Table 1.2 sample was 59 years, suggesting that whilst many had served during the crisis years of the inter-war period, a minority had also participated in the development of earlier directorial cliques. At the same time, it is suggestive that centralization of directors' power acted as a barrier to the development of new managerial talent. Instead of institutional ownership substantial share-ownership by directors, their families and members of founding families persisted. Toms and Filatocthev (2004; 2005) suggest that these governance parameters prevented restructuring and rationalisation of textile industry in the decline environment of the 1960s, and only the emerging market for corporate control "unlocked" turnaround option.

Table 1.2:
The Distribution of directorships in British enterprises, 1950

	Cotton Textiles, 1950[1]	All British Enterprises[2]
Number of directorships per person		
1	19.2%	87.4%
2	13.2%	8.5%
3-5	43.7%	3.9%
6 or more	23.9%	0.2%

Notes:
1. % of directors in each category from a sample of 167 directors from 45 quoted textile companies.
2. % of directors in each category from the top 250 British enterprises. The % is estimated from Scott (1997), p.117 which provides breakdowns for the years 1938 and 1976. The figures shown here are averages for those two years.
3. *Source:* Toms and Filatotchev (2004).

Mature listed corporations may face shortcomings in their corporate governance system that mean that they do not adapt to changed environmental circumstances. For example, they may fail to exit from sectors with limited positive net present value projects and have substantial free cash flow (Jensen, 1993). Taking a corporation private leads to changes in its corporate governance mechanisms aimed at reducing agency costs and increasing the upside incentives for management. Public to private (PTP) buy-outs typically involve significantly increased equity holding by management, concentrated equity holding by private equity firms who also become active investors through their board positions, specification of reporting requirements and other conditions in the corporate charter [shareholders' agreement] by the private equity firm that constrain management, and the pressure to service debt (Thompson and Wright, 1995). Wright et al. (2000, 2001) identified scope for buy-outs of listed companies that may require a reinvigoration of entrepreneurial talent and/or enhanced monitoring. These firms may require quite different managerial incentives and monitoring from the more traditional efficiency oriented buy-outs. Importantly, they may also require a different complementarity between the skills of management, the skills of the private equity investor and the nature of financing. Weir et al. (2005) investigate the factors that influence the decision to change the status of a publicly quoted company to that of a private company. The mechanisms identified in the Cadbury Code would be expected to mitigate the agency problems associated with weak internal governance. An independent board pursuing shareholders' interests is indicative of effective internal monitoring. Thus boards with a greater proportion of non-executive directors as suggested by the Cadbury Code may be expected to be more effective monitors. Similarly, boards that separate the posts of chief executive officer and chairman will be better able to influence decisions. Therefore, duality is less likely to be present in firms going private. More effective external monitoring will occur as institutional shareholdings increase and the free-rider problem is overcome.

Weir et al. (2004) suggest that traditional buy-outs that involve efforts to enhance efficiency require management who respond to enhance financial incentives and private equity firms with financial monitoring skills. They also

suggest, however, that where public to private transactions involve scope for entrepreneurial activity and innovation, there is a need for management with an entrepreneurial mindset, private equity investors required that possess more specific industry skills and a more flexible financing structure with lower leverage that allows the venture scope to invest in more uncertain activities. These differences, therefore, have implications for the composition of boards in these ventures and the recruitment of managers that are as yet not well-understood. To what extent, for example, are boards of directors in PTPs changed to bring in executive and non-executive directors with the skills to grow as well a restructure a business? To what extent, do those fairly common PTPs where the management already have a significant equity stake lead to the release of entrepreneurial activities that were constrained by the stock market or simply the entrenchment of those management?

1.4 Discussion and conclusions

The chapter has identified different roles for corporate governance and taken steps to develop a framework that integrates the relation of these roles to the different stages in the life-cycle of the firm. A theoretical model combining resource and agency perspectives has been reviewed above with reference to significant evidence from a diverse range of empirical studies. It has shown that corporate governance is important, but manifests itself in different roles, at different parts of the life-cycle of firms and organizations, not just in respect of mature firms where most research attention has hitherto been focused. There is a clear indication that successful transition over a threshold is accompanied by a dramatic re-balancing in the structure and roles of corporate governance as compared to each previous stage in the cycle.

This analysis has a number of implications. The framework provides insights for the development of corporate governance codes. There has been some debate about the relative importance of the wealth protection versus wealth creation aspects of corporate governance in attempts to develop corporate governance codes. In the UK, for example, the initial Cadbury Code focused on the former while the Hampel Committee recommendations aimed to shift the emphasis towards the latter (Short et al., 1999). This chapter suggests that the development of ‘one size fits all’ corporate governance codes may be highly problematical for firms at different thresholds in their life cycle. Prescriptive requirements to eliminate duality of CEO and Chair, minimum numbers of external directors, etc. may focus on wealth protection issues in mature companies to the detriment of wealth creation in early stage companies and those companies needing to reinvent themselves. The Combined Corporate Governance Code in the UK provides for smaller listed companies (defined as those smaller than the FT350) to have fewer independent outside directors than larger listed companies, and also requires cross-holdings of directorships to be identified. This research indicates that for firms at different stages in their life cycle, the number of external directors may matter less than the expertise

of those directors and that cross-holdings of directorships may provide access to important resources.

The chapter shows that there is a clear imbalance in the amount of research devoted to corporate governance at the different stages in the life-cycle of firms. It has identified different roles for corporate governance but as yet there is no framework that convincingly integrates how these different roles relate to the different stages in the life-cycle. There is a need for more research that examines the process by which firms change their governance mechanisms as they pass through these thresholds.

In conclusion, this chapter integrates the strategic dynamics of the firm with changes in its governance systems. It has shown that corporate governance parameters may be linked to strategic “thresholds” in the firm’s life-cycle. Its theoretical framework and empirical evidence suggest that the strategic dynamics of the firm is accompanied by changes in its governance system, rejecting, therefore, the notion of a universal governance template. The firm’s evolution along its life-cycle is associated with changes in the balance between the wealth-protection and wealth-creation roles of corporate governance. The right mix of governance functions may help the firm to overcome its strategic thresholds.

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2. Conference Session 2 Corporate Governance and Firm Performance in an International Perspective: Conflicting Empirical Evidence

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2.1 Introduction: The Nature of Corporate Governance Research

Corporate governance is the set of interlocking rules by which corporations, shareholders and management govern their behaviour. In each country, this is a combination of a legal system that sets some common standards of governance and systems of behaviour determined by the firms themselves. Much of the research on corporate governance examines the interaction between the institutional frameworks of governance and the response of firms within those frameworks.

Two main approaches to governance research exist in practice, whether this is based on the economics, financial economics or strategic management literatures. The first is where governance is investigated in terms of an endogenous set of behaviours within the firm. This includes concerns about CEO compensation, the composition of the board, board independence and patterns of ownership, for example, internal or external block shareholders, domestic or international ownership. The second is where governance is exogenous to the firm and is a consequence of national institutions. This includes issues such as how much of a constraint is imposed on the firm by legal restrictions, for example, levels of disclosure, health and safety legislation, the rules on insider trading, the discipline of the market or privatisation of nationalised industries.

In both sets of circumstances the effect can be seen in performance at the firm level as well as having an impact on the economy as a whole, while the extent

of control exerted by senior management is largely confined to the former. However, a dilemma remains since although most large investors may believe that corporate governance is a necessary precondition for good financial performance, a clear causal relationship has not yet been established. Therefore a comprehensive view of the impact of governance on performance outcomes has to examine the interaction between internal and external decisions. Good and bad models of corporate governance exist within firms while institutional failure and poor policy can dilute the benefits of micro level best practice. Indeed, there is often more to be learned about the organisation of the firm from market and institutional failure than success.

This paper will review recent empirical research that relates systems of governance with firm performance, based on three broad research questions:

- *Is evidence of the importance of corporate governance influenced by the way performance is evaluated?*
- *How do firms perform, given their internal model of governance, multiple stakeholders, external constraints and international environments?*
- *Is 'good' governance an input into firm performance or simply a mechanism to minimise agency costs?*

The next section briefly discusses alternative measures of performance, as it will be argued that this can have a major influence on the research outcomes. Section 2 reviews a selection of empirical papers that link governance with firm performance drawing on several country studies. The final section suggests aspects of future research and concludes.

2.2 Measures of firm performance

Three main approaches to firm level performance are found in social science research: research based on market prices, accounting ratios and total factor profitability. Market prices are readily obtained from national stock exchanges for all listed firms and are either in levels or first differences. These data are commonly used in the economics and finance literatures, whereas Tobin's Q[1] is frequently the variable of choice in management and strategy research. In both cases, these present difficulties when assessing firm performance. Firstly, the long-standing conventional wisdom that share prices are a good measure of the value of the firm is based on efficient capital markets (Fama, 1970). However, this has been challenged in the more recent behavioural finance literature (Fama, 1998, Shiller, 2000 and Schleifer, 2000), which claims that for long periods firms can trade on financial markets at prices that do not reflect their fundamental value. Moreover, is it clear that not all markets are efficient, particularly in developing and emerging countries with nascent stock markets that are known to be illiquid and lacking in breadth and depth. Finally, there is

1 This is defined as the ratio of market to book price or the Market Value of Firm/Replacement Cost of the Firm's Assets.

a view that owners are residual claimants on the firm's resources and thus only have claim to income not already paid to prior stakeholders (Sunders, 2001). All of these issues raise questions about the appropriateness of such a measure of firm value. Apart from these purely conceptual issues, there are practical ones. Price data is a continuous time variable and may be highly volatile and therefore the market value of the firm is arbitrary and depends on the precise period chosen. The statistical properties of returns data can also present problems. The popular Tobin's Q is a ratio comprised of a continuous time variable in the numerator and an annual, or semi-annual, value in the denominator. Neither ensures robustness or stability in an estimating equation, however a number of studies relating governance systems within the firm are modelled in this way.

Measuring firm performance using accounting ratios is also common in the corporate governance literature (Demsetz and Lehn, 1985; Ang et al, 2000), in particular, return on capital employed, return on assets and return on equity.[2] Similarly, economic value added can be used as an alternative to purely accounting-based methods to determine shareholder value by evaluating the profitability of a firm after the total cost of capital, both debt and equity, are taken into account (Copeland et al, 1995). The only difficulty is comparability associated with international accounting differences, although this is now less of a problem as most studies use listed firms and reporting practices for these firms are becoming increasingly harmonised. The exception to this concerns alternative organisational forms, such as the sample of South African cooperatives reviewed in the next section. There are not listed firms and accounting for cooperatives is conceptually different from that of joint stock or privately owned organisations.

The third approach is to measure the productivity of firms by modelling economic activity, usually by determining levels of efficiency. Two major advances dominated the production economics literature in the last quarter of the 20th century: the dual form of the production relation such as the cost and profit function and the development of flexible functional forms that can be viewed as second order approximations of any unknown production function. These have been applied to firm or sector level measures of efficiency in a variety of organisations and is based on the concept of a transformation function, which provides a direct, or primal, description of a production technology. A common characteristic, regardless of the approach used, is that of optimality, a maximum or a minimum value that can be achieved within the constraints imposed by the available technology and price structure. Having constructed a boundary or frontier, and assuming a common set of constraints, efficiency is measured by the distance of individual firms relative to that frontier (Diewert, 1982). A number of the papers discussed in the next section of this paper rely on these frontier techniques that determine a benchmark of

2 Defined as: Profit before Tax/Total Corporate Issued Capital, Profit before Interest/Annual Average of Total Assets and Profit before Interest/Annual Average of Owner's Equity, respectively.

best practice.[3] These methods can also be extended to develop micro-level productivity indices, the most useful of which is the total factor productivity index. The ratio of aggregate output to an aggregate of all inputs combined gives a measure of total factor productivity (TFP) or multifactor productivity. The properties of these indices allow the decomposition into scale, allocative and technical efficiency components, and well as identifying factor biases. These characteristics are particularly important in intertemporal studies where the separation of technical change and real efficiency improvements is required. The importance of this general approach to governance research is that it is possible to include factors relevant to the organisation, such as ownership and control of the firm and models of external audit and monitoring while still retaining an economic production relationship. These two aspects, governance and economic activity, can be included simultaneously in the econometric modelling, following the work of Battese and Coelli (1995).

2.3 Research linking governance with performance

Two broadly defined theories co-exist in the corporate governance literature. One stresses the discipline of the market, claiming that threat of hostile takeovers and leveraged buyouts in firms was sufficient to ensure full efficiency. Where managers neglect to invest in those projects that add value to the firm and its shareholders but divert recourses to their own benefit, the financial markets act to restore good governance. A number of mechanisms have been suggested, such as removing senior managers in poorly performing firms (Palepu, 1986, Morch, Shleifer and Vishney, 1988, 1989); demanding cash flow payments in the form of debt service (Jensen, 1986); and linking executive compensation to performance, including equity and options (Jensen, 1986). The other is that this threat of takeover results in managers being concerned with short-term price performance at the expense of developing innovative strategies for sustained growth and thus falling behind foreign competitors that were not under the same pressures (Dertouzos et al, 1989). A solution to this dilemma is that large financial institutions should develop long-term relationships with firms, providing which has become known as *patient capital*.

As will be discussed in the remainder of the paper, evidence on the relationship between firm performance and mechanisms to control agency problems or enhance corporate responsibility is ambiguous. In this section, a number of papers that link various aspects of governance to firm performance are reviewed, grouped around the outcome measures described above.

a) *Stock market measures of firm value*

The most common approach to assessing the governance link with corporate performance as determined by the market is to conduct event studies.[4] This

3 See Fare et al (1985) for the theory and Piesse (1999) for a full review and an application to economic transition.

4 This is usually a means of measuring price efficiency in financial markets, where if there is efficiency, all news is already incorporated into the share price.

examines stock market reaction to unanticipated news or occurrences, and includes the speed and intensity of price response to positive or negative events. This can be an entirely appropriate response, in which case share price can be considered a good predictor of the quality of governance within the firm. An example of this research concerns evidence of the failure of social or environmental responsibility. A predictable fall in the market price of Exxon shares followed the 1989 oil spill from the Exxon Valdez. Shareholders rightly anticipated high clean-up costs and possible fines and this was the case following the judicial review of the incident by the State of Alaska. Criminal damages of $150 million were incurred, the largest fine ever imposed for an environmental crime, with remission in recognition of Exxon's cooperation in cleaning up the spill and paying certain private claims. There was also a civil settlement of $900 million. The company was found to be negligent and had improperly supervised personnel (www.evostc.state.ak.us).

A second example from the same industry illustrates shareholders' response to a positive statement of social responsibility. Firms vary in their levels of compliance with safety regulations. Some simply achieve the minimum standards required by legislation while others exceed these in an attempt to lower the probability of an accident, since they have the benefit of an informed, internal risk assessment. However, this policy can be costly and may deter shareholders that have a purely profit maximising objective function. If an accident leads to a fall in the share price, this may prove a sufficient incentive to ensure high levels of safety. To make a social choice between compliance with safety regulations ex ante, and the threat of liability ex post, it is necessary to measure the effects of safety expenditures in the context of the welfare of society as a whole. This can be defined in terms of the degree of asymmetric information between parties, which is one of the central constructs of corporate governance theory (Shavell, 1984). This hypothesis was tested using the standard market model, where environmental mutual funds were used as a proxy for firms that favoured a pro-active response to environmental risk. The return from these funds was compared with those of neutral mutual funds. The difference was not significantly different from zero, indicating shareholder support for firms with high levels of corporate and social responsibility was positive and not a deterrent, even if the costs of this were higher than strictly set down by safety standards legislation (Piesse, 1992).

But elsewhere ambiguities over the response of the market can obscure the link between the role of internal governance mechanisms and performance as indicated by the share price. The efficient market hypothesis states that all information is incorporated in share prices and conflicting events may not be separable. Two papers are briefly examined, which consider the change in the value of the firm, first because shareholders wished to distance themselves from the disaster and second because of a fall in the demand affected the sector as a whole. They each lead to rather different conclusions. In 1983 the leak of chemicals from the Union Carbide India plant at Bhopal exposed half a million people to the gas and 20,000 died as a result. More than 120,000 people

still suffer from the effects (www.bhopal.com). Marcus et al (1987) speculate on the motivation of managers in maintaining high safety standards. Using the accident at Bhopal as a test, they found that immediately afterwards the share price fell by 50% but this was short-lived and after 90 days it began to recover. Within 160 days the price had returned to the pre-accident level, helped by rumours of a takeover. Although the accident occurred in one overseas division, shares of Union Carbide as a whole were affected during that period and consequently the entire firm was under valued. Ultimately, the shareholders who did not sell immediately after the accident enjoyed a rise in their level of wealth as a result of it.

The other example is a share price fall that was industry wide and entirely unrelated to firm-specific performance. Borenstein and Zimmerman (1988) considered the market prices of all air transport companies following a commercial aircraft accident. Airlines carry insurance against the costs of an accident, both to replace damaged equipment and to compensate for injury or loss of life, but they cannot insure against the loss of revenue that may result due to the public perception that air travel is intrinsically dangerous. However, in this case, the loss in equity value is very small, on average less than 1%, with the information being totally absorbed in the share price the trading day following the accident. After that date, negative abnormal returns are small and insignificant. One reason why the effect is minimal is that unless the specific airline is found to be grossly negligent, new information about the dangers of air travel will lead to a fall in demand in the market as a whole, and so the loss in revenue is shared across the industry. In this case, it is an attitude about a risky activity, rather than the firm, which dominates, and any shareholder who holds a small proportion of airline stocks in a diversified portfolio will have minimised their loss association with this risk.

b) Accounting ratios

Because accounting ratios are constructed from the corporate reported accounts, this research also concentrates on listed companies. Many questions of interest are international and there are numerous examples where the institutional and cultural contexts vary. Methods using accounting ratios vary from simple tests of differences between groups and correlations between governance factors and outcomes, to regression models that simultaneously construct performance frontiers and identify the governance variables that contribute to firm performance.

Modelling the impact of governance using accounting information tends to consider systems internal to the firm, such as board characteristics, including gender mix, size, family participation, duality of chairman and CEO, CEO compensation and the role of supervisors and other stakeholders in the firm. The large body of research in the economics and management literatures is grounded in an agency framework, and relates to the UK/US environment of widely held public corporations. Demsetz and Lehn (1985) claim that the ownership structure of a firm is endogenously determined and reflects

optimising behaviour on the part of managers and investors. Differences in ownership structure arise because the optimal structure differs across firms but they find no systematic link between ownership patterns and performance. Agrawal and Knoeber (1996) extend this work by examining the relationship between multiple agency control mechanisms and performance. The authors separate endogenous mechanisms, such as family shareholding and board composition and external mechanisms, such as the role of institutional shareholders. For the former, these can be set to maximise firm value, but in the latter this is not the case and thus cross sectional variation in firm performance could be related to these factors. Another example is Huson et al (2004), who find that performance relative to other firms deteriorates prior to CEO turnover and improves thereafter. The extent of the recovery is due to the level of institutional shareholding, and outsider-dominated board and the appointment of new senior managers from outside the company. Finally, governance research on European firms, suggests that importing Anglo-American models of governance through board membership by foreigners improves performance compared to other firms in these largely segmented markets and is a more cost effective method than obtaining a foreign listing (Oxelheim and Randoy, 2003).

Despite this wealth of research, little is known about ownership-performance inter-relationships outside widely held public corporations (Bruton et al., 2003). Specifically, there is a dearth of research on family-controlled but publicly listed firms (Gomez-Mejia et al., 2003), which represent a significant part of the corporate sector in many developed and developing countries (Chang, 2003; La Porta et al., 1999). Family-controlled firms play a particularly important role in Asian countries (Joh, 2003), but, with the exception of Japan, most studies of corporate governance related to Asian countries prior to 1998 rely on case study methods of specific industrial sectors (for example, Taniura, 1989; Taniura, 1993; Numazaki 1993). While many have produced interesting results the overall picture of the impact of corporate governance in the region remains mixed.

The 1997 financial crisis in South East Asia has resulted in a plethora of research that has concentrated on the importance of models of corporate governance in countries that are largely organised through a system of family ownership and control of firms (Anderson et al, 2003; Carney and Gedajlovic, 2003). Corporate sector vulnerabilities and weak governance have frequently been noted as contributors to the Asian crisis, particularly the degree of family involvement in firms. Both theoretical work and the empirical literature have gone so far as to place these at the centre of the crisis. There are a number of alternative hypotheses relating the corporate sector to the crisis including: the explanation of poor performance in response to external shocks such as falls in aggregate demand and increases in interest rates and the view that firm performance began to decline before the onset of the crisis and thus left them vulnerable. A theoretical model by Krugman (1999) explicitly incorporates the role of corporate balance sheets in the crisis and directly links governance with performance and the ability to survive economic shocks.

Empirical research on Malaysia supports this theory. Like the other crisis countries, Malaysia is characterized by an insider system of corporate governance, with high levels of ownership concentration, cross holdings and significant participation of owners in management. A few large corporations own a significant proportion of financial assets and productive capacity.[5] Concentration also occurs at the level of stock ownership, which given the large capitalization, is concentrated in the hands of relatively few institutional and corporate investors. Another layer of concentration occurs in terms of control, where cross holding of share ownership, or pyramiding, magnifies the actual control of a few individuals/entities well beyond their actual level of ownership in each company. In addition, the development path of the corporate sector in Malaysia has resulted in some innate weaknesses. Firstly, the development of the private sector under the activist industrial policies of the government has resulted in close ties between government and large corporations. Secondly, the cross-holding structures can create incentives for double gearing, thus creating a multiplier effect in the sensitivity of corporate wealth to changes in the equity market (IMF Selected Issues, 1999). Finally, the concentration of shareholding can lead to poor governance as a small group can exercise control over a firm and pursue the objectives of the insiders to the cost of the outsiders, or small shareholders (Claessens, Djankov, Fan, and Lang (1999)). An additional interesting feature of corporate ownership in Malaysia pre-crisis was the prevalence of nominee accounts. In December 1997, these accounts were the largest of the top five shareholders of listed companies and about half the beneficial owners of the nominee accounts were foreigners.

Research using accounting ratios taken from listed firms financial reports in a stochastic frontier efficiency model found that for the largest firms on the Kuala Lumpur Stock Exchange, ownership concentration had a negative effect on performance outcomes during the crisis (Piesse and Khatri, 2002). It should be noted that different approaches to measuring ownership concentration are found in the literature and numerous indices have been used, each of which have different properties and limitations. The most common are from the Herfindahl group.[6] An alternative approach is to build indices of corporate control that provide consistent estimates of ownership dispersion, within a game theoretic framework. Here, shareholders are modelled as players in a voting game using classical power indices (such as Shapley indices, (see Owen (1982)) to measure each shareholders' relative ability to impose control through coalitions with other shareholders. The method used by Crama et al (1999) is based on the Banzhaf index, where the index of a single shareholder

5 The International Finance Corporation produces concentration indices derived from the largest ten stocks relative to total market capitalization. At December 1998, this was 31.5% for Malaysia and 61.5%, 37.9%, 55.4%, and 45.8% for Indonesia, South Korea, the Philippines, and Thailand respectively.

6 These focus on the square of the proportion of shares that are owned by the largest direct shareholders in the firm. However, problems with Herfindahl indices have been identified, indicating the need for a more meaningful metric. First, the expectation in a typical Herfindahl index is that any dilution of shareholding will lead to a lesser concentration level, but this is not necessarily the case if two or more of the lower ranked shareholders collude, an event not incorporated into the Herfindahl construction. Second, since the emphasis is on the larger shareholders only, the potentially disciplinary effect of collusion amongst floating shareholders is ignored although the organizational costs of this make the event unlikely.

is defined as the probability that the outcome of any decision can be unchallenged despite collusion by other shareholder groups.

Piesse and Khatri (2002) used two measures of ownership concentration in the Malaysia study: the influence reflected by the largest shareholders, and the Crama game theoretic index, both of which were inversely related to firm performance, although the latter was more robust to functional form. In addition, to capture the role of debt in ensuring good governance, long-term debt was included as this can be an important mechanism of control and systems of governance that are debt-based are discussed by Jensen (1986). However, there was no evidence that long-term debt in the firms' capital structure was significant, regardless of whether this was sourced from bondholders or banks. Providers of fixed income capital in an insider system are banks that have a direct interest in the firm, or family members who are also very likely to be directors of the firm. Thus, for insider governance systems, such as Malaysia, debt does not appear to have a parallel role to that proposed by Jensen for countries with outsider structures of corporate control. This study found that, prior to the crisis, performance in the Malaysian corporate sector was already, although dramatically worsened as it developed.

However, a number of Asian countries did not experience a dramatic fall in economic performance during the crisis period, while still maintaining a close family ownership structure (Rajan and Zingales, 1998). This is not surprising, since the economic environment within countries of the region varies substantially, despite common elements such as cultural background, the nature and extent of institutions and the level of economic development. Therefore, a single model of corporate governance for all Asia is unlikely although Mitton (2002) found that governance mechanisms, especially monitoring activity, are critical to corporate performance for firms in the region. Filatotchev et al (2004) investigated a model of corporate governance in a different institutional environment, focusing on listed firms in Taiwan. This paper analysed corporate governance effects on performance in situations where the managers are frequently family members, where families are also represented on a supervisory board, and where they are often the major providers of capital, if not directly, then through relational holdings in other firms.[7] These family-controlled firms are listed on the stock exchange but also have minority shareholders to whom managers are accountable, and governance effects of the interaction of family control with external share ownership on performance is therefore an important research issue. The paper examined to what extent concentrated shareholdings by institutions can provide an effective counter-balance to families' opportunism and so improve firm performance, similarly with outsider representation on corporate boards.

Contrary to the assumption of the law and economics research (Claessens et al., 2000; La Porta et al., 1997, 2000) no direct association between family

7 In fact, specific levels of equity ownership is mandatory for both directors and supervisors in Taiwan.

ownership and managerial entrenchment and extraction of the private benefits of control which should be detrimental to financial performance was identified. In addition, although previous research provides ambiguous results in terms of the possible effects of external block-holders on performance (Maug, 1998;), these results confirmed a positive and significant relationship between institutional share ownership and all performance proxies after controlling for possible endogeneity. These results were consistent with a block-holder coalition framework that suggests an incentive alignment effect of a coalition of large shareholders that reflects a positive relation between the cash flow stake of the controlling coalition and total firm value. In this environment it appears that the presence of institutional investors provides an effective remedy to the principle-principle agency relationship that exists in family-controlled firms (Young et al. 2002), especially in the absence of a market for corporate control.

This research also supports similar studies that identify differences in corporate governance effects associated with different types of institutional shareholders. Previous papers have recognised the different governance effects of various types of institutional investors (Tihanyi et al., 2003; Hoskisson et al., 2002). In particular, the findings emphasise the importance of foreign institutional investors in terms of performance outcomes. The process of globalisation of Taiwanese capital markets may lead to good governance practices being imported by domestic firms, and future research on this issue may have very important implications for other emerging market economies that want to attract foreign investors.

Additional results provided evidence of selectivity in terms of the effects of various board characteristics on firm performance. Although previous research does not generate compelling evidence of positive outcomes related to board independence (Brickley et al, 1994; Xie et al. 2002), these findings suggest that family control over the executive board is detrimental to performance. Combined with a lack of evidence of family ownership effects on performance, board dominance may be another channel through which families may try to extract the private benefits of control. This result can be used to develop further law and economics research on the private benefits associated with voting rights. The results also suggest that such an important board characteristic as the presence of an independent Chairman does not seem to affect performance. Considering that previous research associated Chairman independence with more efficient monitoring and control of managerial discretion by focusing mainly on publicly owned organizations in the West, it is possible that in the context of Taiwan, connections and social capital may be of vital importance, and the removal of such an individual may have a negative impact on the firm. Further research on this very important issue is in order. Finally, the work on Taiwan represents an important step in understanding the financial dependence perspective (Hambrick and Jackson, 2000) by providing strong evidence of links between the financial commitment of the board members and organizational performance.

In summary, previous research has focused on separate organisational outcomes of family/insider owners, outside block-holders and board characteristics (Dalton et al., 2003; Daily et al., 2003; Gomez-Meija, 2003). The results of this study strongly point to the need to develop an integrated conceptual framework that should bring together the analysis of simultaneous performance effects of various insider and outside investors, as well as their participation in corporate boards. Since alternative control mechanisms exist, an intensive use of one of them should not necessarily be associated with superior firm performance

c) Productivity: economic performance and efficiency

The final selection of papers to be reviewed approach the measurement of firm performance where economic outcomes are determined by the amount of outputs that result from the use of inputs, thus accounting for the operational efficiency of the firm. The inputs and outputs are either in physical units or value terms. Three papers are discussed here, each of which address corporate governance, either in the context of the ownership structure of the firm and the incentives this provides or the response of managers to changes in legislation that have an impact of the control and accountability of managers to shareholders.

While empirical evidence, especially from China and the transition economies of the former Soviet block, indicate that privately owned firms often are more productive and better performing than state owned firms (Zhang, Zhang, and Zhao 2001; Claessens and Djankov, 2002), this debate is by no means over. Agency theorists argue that a privately owned firm may not be productive or be able to perform well because of conflict of interest between different groups of stakeholders within the firm (Jensen and Meckling, 1976). Indeed, research suggests that private firms may not always take decisions that are consistent with the principle of profit or value maximisation. Therefore, it has been argued that privatisation of state owned firms is not necessarily a panacea, and that, as an alternative to privatisation, state owned firms can be rendered efficient by way of competition and implementation of hard budget constraints (Caves and Christensen, 1980; Brown and Earle, 2000; Januszewski, Koke and Winter, 2002; Isik and Hasan, 2003).

The first paper examines the progress of the economic transition in Eastern and central Europe, using firm level data from Hungary. Production and efficiency is modelled in two important industrial sectors in the early stages of the reform (Piesse and Thirtle, 2000). Regardless of the nature of the underlying economic system, technical, as opposed to allocative, efficiency in the use of resources is always an objective. Relative efficiency can be measured by applying stochastic frontier techniques to the individual annual samples, but in many cases differences are a function of inadequate models and data, even when the frontier is stochastic. The standard economic model (Berndt and Wood, 1975; Berndt and Khaled, 1979) is used for the production

function with governance variables to explain why some firms were operating at some distance from those on the frontier of best practice.

The transition from a supply driven structure to a market demand-led economy presents a number of difficulties. To monitor the progress of the reform it is necessary to develop a robust system of measurement that can identify trends in productivity that are sufficiently credible to be used in policy formulation. There is no doubt that there was a serious recession during this period, caused by a combination of supply-side and demand-side factors, as discussed extensively in Blanchard (1991). In the early stages of the transition, Hungary suffered from a variety of problems including inefficiency, technological backwardness, widespread poverty due to unemployment and inflation, incomplete institutional reform and lack of infrastructure. Kornai (1994) argued that the private sector is the force on which Hungary could reply for overcoming the recession. However, reductions in income resulted in insufficient demand thus retarding private sector development.

Apart from these production variables, the data included numerous other items. The distribution of ownership, defined by the Hungarian Finance Ministry, assigned broad categories including state administered, self-managed, limited liability and a number of co-operative type structures. While it is safe to assume that few firms in the sample actually changed their ownership status during the period of this study, many may have undergone a great deal of internal reorganization. Since this is generally a result of the introduction of market reforms, in particular hardening budget constraints, these are precisely the changes the model should capture.

A major consequence of the reforms, noted in all of the countries in central and Eastern Europe to some degree, was the decline in production. The governance implications for these firms were that for those for whom the decline was small or the recovery quicker, two major factors were contributory: the extent to which they were funded privately through bank loans rather than a continued reliance on the state, and the scale of senior management salaries compared with those of the other employees. Those firms that were able to comply with the hard budget constraint enforced by the newly independent financial system were able to compete in the new environment. Equally, the firms with managers that did not expropriate profits but established a salary structure that provided incentives but not excessive compensation also survived the initial recession.

India also experienced substantial reform, particularly of the financial sector, resulting in a major restructuring of banks, which are the main source of funding for firms and individuals in a developing country. The majority of domestic banks in India are state owned, although some of these had been privatised. In addition, new privately owned domestic banks were established and foreign banks allowed to enter the market, generally as branches of multinational banks. Productivity measurement in the financial sector

commonly models banks either as productive units or as intermediaries. Several papers have examined the link between ownership, competition and performance among financial intermediaries including banks. The empirical evidence from a few studies that analyse the relative performance of state owned and private sector banks suggests that the relationship between ownership and performance can be weak (Sarkar, Sarkar and Bhaumik, 1998), especially in emerging markets where private ownership alone may not ensure profit maximization, and that competition can induce state owned banks to bridge the performance gap with the privately owned banks (Bhaumik and Dimova, 2004).

The literature linking ownership and competition to performance of banks focuses on the efficient allocation of credit. If bank credit is allocated to the most productive projects, the probability of project failure and therefore the likelihood of loan default is low. The ability of banks to allocate credit to the most productive projects at a low cost to themselves is a function of both their ownership structure and the extent of competition. Specifically, it is believed that even though private ownership of banks is not necessarily a panacea in so far as financial performance and productivity is concerned, in general, a state owned bank may be less able, and perhaps less inclined, to assess the risk associated with individual projects and borrowers accurately (Banerjee and Duflo, 2001). That is, the allocative efficiency of credit increases with the proportion of privately owned banks in the industry.

However, private ownership of banks does not necessarily have a similar salutary impact on the volume of credit disbursed by the banking sector. It is now established that if profit maximising banks, facing an uncertain economic environment, are apprehensive about the possibility of adverse selection with respect to their loan portfolio, they are likely to ration credit and reject potentially risky borrowers (Stiglitz and Weiss, 1981). Indeed, in emerging markets, where many of the projects are inherently risky because of unfavourable macroeconomic and market conditions, as well as because of factors related to the political economy of regulations governing credit disbursal and contract enforcement, banks have been known to effect credit rationing (Ma and Smith, 1996). The extent of credit rationing undertaken by a bank is clearly an increasing function of the degree of risk averseness. Since privately owned banks are more likely to be risk averse about contingencies that impact on their balance sheets and profitability than state owned banks, given that the management of these banks are held responsible for their financial health by the private owners, private banks may be less willing to expand their credit in an emerging economy than state owned banks. The problem of credit disbursal is likely to be even more acute for foreign banks that are subject to stricter market discipline in their countries of origin.

Therefore while corporate governance and corporate finance theorists may argue that state owned banks are, on average, less cost efficient and less profitable than their private sector counterparts, and should be privatised, a

policymaker who has to take into consideration the growth potential of an economy, of which the volume of credit disbursed is an important determinant, may be more hesitant to abolish state owned banks. This may be even more pronounced in countries like India, where nationalisation of banks in 1969 and the subsequent increase in the breadth and depth of the credit market are viewed as a key ingredient of economic growth and development (Ketkar, 1993; Bell and Rousseau, 2001). Existing literature on Indian banking indicates that, starting from little competition in the immediate aftermath of the reforms in the early 1990s (Sarkar and Bhaumik, 1998), competition in the Indian industry grew steadily (Shirai and Rajsekaran, 2001) such that there was a convergence between the operational performance of public sector and other types of banks over time (Bhaumik and Dimova, 2004).

Using bank-level data from India, a production approach shows that while foreign banks have high credit to deposit ratios, the domestic banks experienced much greater improvements in technical efficiency in the context of credit dispersion (Bhaumik and Piesse (2004). The most significant improvements in technical efficiency are observed by the domestic de novo banks. There is weak evidence that foreign banks provide innovations in the sector but these are only for the benefit of high wealth, low risk borrowers, and technology spillovers between the types of banks was minimal. These results emphasise the dominance of competition rather than changes in ownership as a policy objective for banks in an emerging market economy. The presence of foreign banks in the Indian credit market has coincided with a steady improvement in the technical efficiency of the domestic banks such that the domestic banks were on average becoming more efficient than the foreign banks that had an initial advantage with respect to technical efficiency. The impact of liberalisation of the banking industry and the resultant competition are palpable. Importantly, these results support other research that indicates the domestic de novo banks outperform the others with respect to both profitability and technical efficiency (Bhaumik and Dimova, 2004). If policymaking for the banking sector in an emerging market involves both an improvement in the profitability/viability of banks and the best possible use of banking resources to disburse credit that is important for economic growth, the emphasis should be more on liberalisation that encourages entry of de novo domestic banks into the industry than on foreign direct investment related reforms that reduce the barriers to entry of the foreign banks. Competition, rather than foreign ownership, will be of greater benefit to the banking sector in emerging economies.

The last study examines the impact of reform in the goods market although there are secondary effects on the provision of financial intermediation. Major institutional change resulted in organisational restructuring of the South African grain sector, which had operated on a cooperative basis since the Marketing Act of 1937 and the Cooperative Societies Act of 1939. Prior to deregulation, the cooperatives supplied inputs and sold outputs through marketing boards and also acted as financial intermediaries by implementing

discriminatory policies devised by the state that favoured commercial over indigenous producers. However, as part of the transition to democracy in South Africa, and majority rule following the elections of 1994, reforms were introduced that included abolishing the marketing boards and the fixed pricing associated with them. This resulted in a change in the financial structure of the cooperatives and consequently their role in the industry. As the environment moved from state control to a free market, the cooperatives made the transition from policy instruments of the state to market-orientated agri-business firms. They ceased to provide low cost credit to their members and concentrated on the standard functions of supplier cooperatives, similar to those in Europe and the US.

The behavioural decisions made by the directors of these cooperatives in the face of major reform was modelled by estimating a production function with governance variables to explain differences in performance over the period of change (Piesse et al, 2005). Results show that the need for internal governance became critical following the move to competitive markets. Three factors were particularly important. First, directors' compensation increased sharply following the reforms and this had a negative impact on productivity. However, the reasons for these increases may reflect either the contribution of experienced managers who would have a positive impact on performance in the longer term, or greed not controlled by the system of governance in the organisation. These conflicting explanations led to insignificant regression results. Unfortunately, information on any change of leadership was not available. Secondly, the amount of bad debts by members and non-members written off is a measure of both poor credit decisions and the overall macroeconomic condition of the sector. The reduction in members bad debts provides evidence of the tightening of financial control, while some cooperatives excluded non-members from financial services after the reform entirely. Clearly, cooperatives were imposing hard budget constraints internally, when the environment was no longer protected and competition was introduced. Finally, costly audit fees were significant and positive pre reform and significant and negative afterwards. Prior to deregulation, the cost of audit reduced net income and was detrimental to performance because costly monitoring of the distribution of state subsidies and loans is simply a drain on resources. However, after the reforms, auditing has a large positive impact, indicating that financial scrutiny became highly productive in the new competitive market. Thus, the introduction of competition and improved governance practices improved the performance of these cooperatives. Furthermore, with respect to contemporary models of governance, these cooperatives lowered the transactions costs of their members, who are the equivalent of shareholders in a listed firm. Subsequently, the market for corporate control has resulted in some cooperatives relinquishing their mutual status and moving to a stock market listing while others have been acquired or left the sector altogether.

2.4 Conclusions

This paper has reviewed a number of papers that seek to provide a link between firm performance and governance. The early discussion on different methods of measuring performance outcomes suggested three main approaches: market price, accounting ratios and modelling firms as productive economic units. These allow different aspects of governance research to be considered. Events that are either exogenous to the firm or result from the market perception of firm behaviour can readily be assessed by share price changes although these may not provide appropriate responses due to the inability of the market to correctly predict or interpret outcomes or separate a number of different effects. This can lead to results such as a sharp fall in price following poor safety practices, followed by an acquisition announcement that reverses the share price, although not the livelihoods of those affected by the consequences of the firm's behaviour. Accounting ratios are less open to market sentiment and provide a more consistent estimate of firm performance. These studies are more reliable and allow characteristics of the board and family control to be captured with certainty. However, modelling firm behavioural decisions, either by econometric estimation of production relationships or total factor productivity indices where changes can be explained by governance variables result in a far richer set of results.

The papers included here review recent research in a number of international environments where the institutional contexts vary and the systems of corporate governance within the firms are quite different. However, a number of topics have been excluded and present interesting areas for future research. Firstly, the question of how models of corporate governance can be imported into firms is only now being investigated. Two possibilities exist. Firstly, cross-listing on international stock exchanges that have more rigorous disclosure requirements than domestic markets has mainly been driven by the need to attract foreign investors although valuable governance effects can spillover and benefit purely domestic firms (Davis and Marquis, 2004). Due to the high transactions costs involved, foreign listing only occurs in large and successful firms but these could provide a benchmark of good practice that can be more widely learned. Second, foreign direct investment can also introduce governance systems to host country organisations (Cornelius and Kogut, 2003). Both of these questions require more empirical testing as time series data become available and the potential link between the lags in imported governance practices and firm performance can be measured.

A second area that has been largely neglected in corporate governance research is the examination of organisations that operate with different objective functions. The not-for-profit sector is becoming increasingly important in the UK economy, for example, in the education, healthcare, culture and leisure sectors. In many cases they compete directly with for-profit organisations. This has interesting implications for corporate governance and relative performance outcomes. Standard agency theory suggests that monitoring by outsiders is crucial in ensuring firms are efficient, but the

formal governance mechanisms in not-for-profit organisations appear very weak. There is no market for corporate control and boards of trustees are frequently self-perpetuating. Directors often are not paid and the usual incentive systems are not in place. This is an area of future research and suggests that a broader definition of firm performance may be necessary.

The task of social science research is to observe behaviour and measure the effectiveness of organisations within the wider economy. This is heavily dependent on data that is robust, accurate and timely and is available at the lowest level of aggregation. The subsequent analysis is useful to government, both to assist in setting policy and also to evaluate the effectiveness of those policy decisions. Communication between the two is therefore essential.

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3. Conference Session 3 Reforming Stakeholder Models? Comparing Germany and Japan

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3.1 Introduction

This report concerns the diversity of national corporate governance systems in light of recent reforms around the world. A growing body of literature on comparative corporate governance has attempted to describe and explain the similarities and differences in corporate governance across countries. Yet corporate governance is itself undergoing rapid development in light of new international standards, domestic public policy initiatives, and the changing policies and practices of corporations themselves.[2] Likewise, corporate governance reform around the world is often informed by the principles underlying the U.S. or UK models of corporate governance – such as shareholder rights, transparency and disclosure, variable management compensation, and the use external independent directors. Unfortunately, the evidence base on the determinants and impacts of corporate governance reform remains weak.

This report will compare the process and outcomes of corporate governance reform in Germany and Japan, two leading "models" of stakeholder or bank-based corporate governance. Section 1 will outline recent debates on corporate governance and identify some gaps in comparative research. Section 2 will outline the similarities and differences between Germany and Japan. Section 3 looks at selected areas of reform: legal reform, the role of banks, and the role of employees as corporate stakeholders. Section 4 explores the implications of the German and Japanese cases for issues of international convergence and public policy.

1. The author thanks Hideaki Miyajima and Andreas Moerke, as well as participants of the DTI conference for useful comments.

2. The term 'reform' is used here to encompass all three sorts of changes.

3.2 National Diversity and Corporate Governance Reform

Shifting Paradigms

Given the differences in corporate governance around the world, which paradigm is best? In the 1980s, much research aimed to explain the comparative advantages of the Japanese and German models, which appeared to be different but in some ways out-competing the U.S. and Britain. The Anglo-American corporate governance was criticized for its short-term orientation, whereas firms in Japan and Germany were better able to develop and implement long-term strategy. This debate changed radically by the mid-1990s. The virtues of the U.S. model were rediscovered in light of excellent macroeconomic performance, as well as the success of venture capital start-ups and entrepreneurship in fields of information technology. Britain also appeared comparatively successful in attracting foreign direct investment and lowering unemployment.

Meanwhile, Germany and Japan entered long periods of crisis. Germany suffered increased unemployment and slowed growth under the costs of German unification. The post-bubble Japanese economy exposed massive non-performing loans that led to a serious and still ongoing banking crisis. More generally, domestic debates became at least somewhat more critical of long-term commitments among company stakeholders, which were argued to impede corporate restructuring and be a drag on the macro-economy.

The wave of the optimism about the U.S. model peaked at the height of the stock market bubble in the year 2000. One result was a substantial shift toward an apparent global consensus about the elements of good corporate governance, reflected in the OECD corporate governance principles (OECD 1999) and the proliferation of codes of corporate governance worldwide (Aguilera & Cuervo-Cazurra 2004), many inspired by the UK Combined Code.

The Fragile "Global Standard"

Since the spectacular scandals such as Enron and crash of the bubble in high tech stocks, scholars and practitioners have started to realize that the global standard is more fragile than initially expected. The US paradigm of corporate governance is rooted in a particular set of assumptions about human motivation, legal rules and the capacity of markets (Blair 2003). The starting point is the notion that the corporation belongs to shareholders, and corporate governance is about aligning the interests of management with those investors (Shleifer & Vishny 1996). This approach relies on a strong appeal to managerial self-interest, often through high-power compensation packages incentives such as stock options. Meanwhile, managers get not only carrots, but face sticks as well through legal rules and the discipline of markets. These elements form a system of external controls comprised on several important elements.

First, a prerequisite for external control is transparent information. People outside the company have to know the true situation inside the company. Disclosure of information must be rapid, transparent, and public in the sense that all investors receive the same information about the company.

Second, transparency is assured or underwritten by the independence of outside directors or auditors. Only independent persons are thought to be able to act as effective checks and balances on the power of inside management. Serious issues remain about the selection process and factual independence of outsiders from the CEO. Another concern is that outside directors are motivated through the same set of incentives as inside management.

Third, building upon transparency and independence, markets may properly value the firm based on a true and fair view of the business situation of the company. Bad performance of the company will result in sinking share prices, and the share price gives an important signal to management. Sinking share prices will ultimately expose companies to a market for corporate control (Manne 1965). Market forces are thus thought to play an important role in corporate governance through takeovers of poorly performing companies, which can then be restructured under a new management team. The governance role of markets remain controversial, given the potential for myopic valuation by investors (Bittlingmayer 1998) and the danger of "breach of trust" if takeover raiders redistribute stakeholder wealth (Shleifer & Summers 1988).

The fragility of this corporate governance model was exposed by scandals at companies like Enron and Worldcom, and it showed that the Anglo-American paradigm rests on a potential paradox. The effectiveness of external control mechanisms presupposes the trustworthiness, honesty and cooperation of people inside the company. But the strong appeal to the self-interest of managers within this approach may, itself, subvert those values of trustworthiness and cooperation and render those external controls ineffective. Professor Michael Jensen, who was a leading advocate of takeovers in the 1980s and before, responded to Enron by warning that the overvaluation of share prices may be just as dangerous to the survival of a company as undervaluation (Fuller & Jensen 2002). Perhaps managers should "just say no" to Wall Street investors and earnings analysts? Perhaps CEOs should have the conscience to forego the enormous rewards offered by markets? The short-termism debate has nearly gone full circle.

Gaps in Comparative Research

Despite the fragility of the "global standard," Anglo-American corporate governance remains a standard reference point or benchmark for comparing other countries. Likewise, changes in corporate governance are discussed largely as a process of international convergence. However, the diversity among corporate governance systems in the non-English speaking world is

actually not very well understood. In particular, I identify three major gaps in comparative research.

First, “stakeholder” models of corporate governance are not well understood in their own terms. Both shareholder and stakeholder theory are essentially normative theories about the proper distribution of rights and rewards in the firm, based on differing sets of assumptions (Dore 2005). They provide normative prescriptions of what corporations should be like, rather than empirical theory and bodies of evidence that explain real patterns of corporate governance. Shareholder theory asserts that corporations are the property of shareholders, who bear residual risk and, therefore, should have the rights of control in corporate management (Fama 1983). Likewise, stakeholder theory stresses that other stakeholders such as employees contribute to economic value of the firm and similarly bear risk based on firm-specific investments (Parkinson & Kelly 2001). Yet neither theory sufficiently addresses situations where the interests or rights of different groups conflict.

Second, the strengths and weaknesses of different corporate governance models are not well documented empirically (see Piesse in this report). Again, this is particularly true for non-Anglo-American systems. Recent work suggests benefits of ownership by large blockholders in terms of greater control over management. Likewise, coordination among stakeholders such as employees, banks and suppliers may bring benefits in terms of incremental innovation and productive efficiency in the context of long-term commitments (Hall & Soskice 2001). Corporate governance may also differ over the lifecycle of firms (see Filatotchev in this report), thereby placing very different demands on the institutional frameworks for corporate governance. These points can be summarized by the notion of different corporate governance systems having comparative institutional advantages for different types of economic activity across countries (Hall & Soskice 2001). Corporate performance is influenced by multiple dimensions of efficiency, but it may be very hard to determine either a priori or empirically what dimension is most important in a particular situation (Jackson 2005b).

Third, an emerging literature suggests viewing corporate governance as a system of interrelated elements having strategic or institutional complementarities (Aoki 1994, Milgrom & Roberts 1994, 1995). One institution may reinforce or have effects that are contingent upon the presence of other complementary institutions.[3] Complementarities make an important contribution to understanding comparative institutional advantage, since relative efficiency of a governance practice depends on the surrounding institutional context. One key implication is that cross-national transplantation of best practices faces serious barriers, since a borrowed practice is unlikely to “fit” within a different systemic context (Streeck 1996). This raises a question

3. A classic example is the long-term nature of bank finance in Japan, which is thought to reinforce the stability of lifetime employment, since managers can make credible commitments to employees in the absence of short-term capital market pressures.

as to whether corporate governance systems will cluster along two internally consistent types, either a pure market type or a pure relational type (Hall & Soskice 2001). Alternative "mixed" or hybrid forms of governance are argued to be unviable or lead to inferior performance (Hall & Gingerich 2003). Still, as many countries now undergo corporate governance reform, the result seems a more complex mix of elements from both shareholder and stakeholder models.

An Agenda for Studying Reform

Even as researchers compare national differences in corporate governance, the nature and extent of that diversity has itself become a moving target. Most comparative work starts from a perspective of comparative statics. Meanwhile, the extent and impact of change in corporate governance is not yet well researched but raises several interrelated issues:

- **Policy Process:** What determines the extent and direction of corporate governance reforms across countries? What is reform influenced by political dynamics such as electoral systems, party systems, business associations, or ideologies?
- **Policy Approaches:** What are the determinants and impacts of mandatory regulation (e.g. uniform requirements) vs. enabling regulation (e.g. removing past restrictions, allowing choice of structures) in promoting corporate governance reform? What role do forms of soft-law such as voluntary corporate governance codes, self-regulatory norms of professional groups and voluntarism play in relation to legal and regulatory factors in different countries?
- **Balancing Different Governance Demands:** How should policy-makers balance adaptation to international norms with preserving distinctive strengths of their national systems? Given the affinities between corporate governance and firm's lifecycles (e.g. start-up promotion, mature firms, and restructuring or wind-up), how should these different governance needs be balanced within a single institutional framework? Given the different national traditions regarding the relative importance of shareholder vs. stakeholder rights, how can positive sum approaches be developed to address the distribution of rights and rewards?
- **Outcomes:** To what extent have corporate governance reforms achieved their expected outcomes in different countries? To what extent have those changes in national systems led to a convergence of corporate governance around the world? To what extent have different countries been successful in importing new international "best practices" in corporate governance?

The remainder of this report will compare the nature and extent of reform in corporate governance in Germany and Japan. Much debate surrounds the extent and impact of reforms in these countries. However, given the common challenges for bank-based and stakeholder-oriented models of corporate governance, the comparison of Germany and Japan seems particularly timely.

3.3 Stakeholder Models, but How Different?

Corporate governance here is defined broadly in terms of the institutionalized rules, but also beliefs that shape how stakeholders might interact in corporate decision-making (Aguilera & Jackson 2003). Germany and Japan are often seen deviating from an economic model of shareholder control and thereby viewed as being similar by virtue of their mutual contrast with the United States. Various labels are used to describe these systems, sometimes uncomfortably, such as bank-based, insider, stakeholder, coordinated or nonliberal models of corporate governance. However, only a small body of literature directly compares these models with one another. A small but growing literature, now tries to more systematically understand the similarities and differences between these two models (Dore 1996, Dore 2000, Streeck & Yamamura 2001, Yamamura & Streeck 2003) or differentiate among various East Asian, Latin and other European models (Aguilera & Jackson 2003, Nam & Nam 2004, Schmidt 2000, Whitley 1999).

Similarities

Germany and Japan indeed have a striking number of similarities. Corporate ownership is typically concentrated among a stable network of strategically oriented banks and other industrial firms, rather than fragmented among individuals and financially oriented institutional investors.[4] Consequently, the market for corporate control is largely non-existent. Meanwhile, banks play the central external governance role. Banks extend relational financing, commingle debt and equity, provide financial services and also take on monitoring roles, particularly in times of financial distress. Japanese main banks act as delegated monitors through direct equity stakes, credit, and dispatched directors (Sheard 1994). German universal banks are linked to business through credit, equity stakes, the exercise of proxy votes, and supervisory board representation (Vitols 2003).

Employees also exercise voice within corporate governance through participating in company decisions, such as legal rights to codetermination in Germany or extensive use of joint labour-management consultation in Japan. Codetermination (Mitbestimmung) involves legal rights to information, consultation, and codetermination for works councils representing employees at the plant and company levels. Employees are also allocated between one-third and one-half of the seats on the supervisory board, placing them alongside shareholders in appointing and monitoring management, giving business advice, and ratifying important strategic decisions with the shareholder representatives. Japanese labour-management consultation is less formalized in law and more restricted to the core workforce among large corporations. The importance of employees is reflected in long employment tenures, infrequent use of lay-offs and high investment in firm-specific skills.

4. Thus, unlike Anglo-Saxon institutional investors oriented to financial gains from share-price appreciation and dividends, ownership is primarily held by investors with strategic organizational interests in promoting inter-firm cooperation, reducing risks, and generating relationship-specific rents.

Top mangers in both countries tend to be internally promoted, and compensation schemes lack strong shareholder-oriented incentives such as stock options. Top salaries are much closer to those of average employees. Perhaps without too much exaggeration one might say that managers are more focused on managing the business, rather than managing the financial numbers. In short, the resulting "coalition" of stable investors, banks, employees and insider management was widely considered to have been a successful model of governance and one that contributed to the strong comparative institutional advantages of German and Japanese firms in markets characterized by incremental innovation and the manufacture of high-quality products (Aoki 2001, Hall & Soskice 2001).

Differences

Germany and Japan also display key differences. One difference centres on the more extensive role of use of law in Germany. Codetermination is a legal institution where employee voice is a matter of public interest and supported through politics. Likewise, the two-tier board system reflects a strong legal intervention into the internal make-up of the enterprise in order to promote effective checks and balances between management and shareholders. These features contrast sharply with the much more informal arrangements of employee participation in Japanese firms, as well as the lack of separation between monitoring and management functions within Japanese boards. These differences are sometimes contrasted as a constitutional model of firm in Germany versus a community model of the firm in Japan (Jackson 2001).

Other differences concern how corporate governance functions are connected with the external environment. In Germany, collective bargaining takes place through sectoral level bargaining between industrial unions and employers associations. Likewise, worker training takes place through an extensive apprenticeship system that coordinates and gives public certification to training efforts by companies. Meanwhile, Japanese unions are organized around enterprise, rather than industry or occupational lines. Sectoral business associations also tend to be weaker, and coordination across firms takes place on the basis in business groups (keiretsu), either vertically (Toyota and their supplier, for instance) or horizontally organized (like in the Mitsubishi group). Japanese keiretsu groups link corporations and banks within extensive patterns of horizontal cross-shareholding (Gerlach 1992), while being very different from the pyramidal conglomerate holding companies (Konzern) in Germany where corporate ownership is much more vertically concentrated (Beyer 1998). Thus, important differences are apparent in the relative importance of horizontal "class" identities versus vertically segmented "enterprise" identities as a basis of economic organization (Dore 1996).

3.4 Comparing Corporate Governance Reform in Germany and Japan

Pressures for Change

Despite the past success, Germany and Japan have recently faced strong pressures to change their corporate governance systems.

First, internationalisation has created pressures to move toward a more market-based or shareholder-oriented model of governance. International finance and investors have become increasingly important. In Japan, foreign investors owned 18.3% of stocks listed on the Tokyo Stock exchange in 2002, compared to 4% in 1990 (TSE various years). Foreign direct investment has increased. Foreign companies made unprecedented acquisitions of large stakes in Japanese companies such as Nissan or Mitsubishi Motors or Chugai, as well as bankrupt institutions like the (then nationalized) Long-term Credit Bank of Japan (now the successful Shinsei bank).[5] Meanwhile, bond finance also plays an increasing role in substituting for indirect financing via banks. Similar trends apply to Germany, where foreign ownership has similarly increased and major international mergers and acquisitions have become common for German blue chips.

International standards are also playing a growing role in corporate regulation. One example is extra-territorial application, as in the case of international accounting standards or the Sarbanes-Oxley Act. In Germany, EU efforts to harmonize capital market regulation have had a profound impact for financial market liberalization and promotion of market-oriented standards. While international regulation has yet to directly affect the core issues of corporate law, the environment of financial regulation has changed dramatically.

Second, domestic patterns of deregulation and liberalization also have created new pressures. Financial deregulation in the 1980s and the collapse of the Bubble economy contributed to the huge problem of non-performing loans (NPL) held by Japanese banks. The NPL crisis has greatly eroded the capacity of Japanese banks to play their former beneficial role in corporate governance. Meanwhile, also in Germany, the availability of internal and direct finance liberated large firms from their dependence on banks, and the banks themselves have undergone strategic reorientation toward new business models. Both countries also face issues of slowed growth, an ageing society and reforms in pension finance. These factors have also promoted some rethinking about the role of corporate welfare institutions, as well as created greater interest in revitalizing the stock market.

5. Overall inward FDI relative to GDP remains extremely low in Japan compared to other countries, but has increased concern about corporate reform to attract more international investment, such as reducing cross-shareholdings, facilitating M&A, privatizing government business or liberalising the use of stock options that U.S. and other foreign firms perceived as necessary to attract qualified staff.

Third, the advent of new information technology industries is often seen to place changing demands on corporate governance. Here the U.S. is perceived as having renewed competitive strength due to its liquid stock markets, venture capital, and strong external labour markets with portable professional qualifications. Meanwhile, German and Japanese corporate governance have supported more integrated and network-based production models stressing incremental innovation and the strong development of shop floor skills. These corporate governance institutions flourished under conditions of strong economic growth, but may appear less well suited to deal with slowed growth, restructuring, mergers and acquisitions, or decline of mature firms. Thus, the life-cycle demands upon corporate governance institutions has become more diverse and exposed gaps in the mechanisms for promoting both new venture entrepreneurship and corporate restructuring (Filatotchev & Wright 2005).

To explore how these countries were reacting to such pressures, this section compares continuity and change in four broad areas: corporate law and regulation, the financial system and the role of banks, issues of employees as stakeholders and labour management. The striking finding is the simultaneous presence of both change and continuity, as well as the continued relevance of more 'traditional' elements of the German and Japanese models within a more liberalized international environment.

Legal and Regulatory Reform

Germany and Japan have each underwent a series of legal reforms since the mid-1990s. Although each has been incremental in terms of numerous small legislative measures, the parallels are striking and the cumulative impact likewise profound (Jackson 2003, Nietsch 2005, Seki 2005, Shishido 2005).

A first series of changes concerns the liberalization of how corporate equity is used, such as share swaps, stock options, and spin-offs. In the case of Japan, the post-war ban on pure holding companies was removed. These changes are largely policy-push reforms lobbied for by corporations to facilitate corporate restructuring, but also give managers greater scope to actively "manage" stock prices. A second set of changes concern movements toward international accounting standards. Both Germany and Japan had rather creditor-oriented accounting principles that stressed conservative valuation and allowed for substantial building of reserves. New market-oriented rules introduce much greater volatility into corporate balance sheets, as long-term stable shareholdings are now increasingly marked to the market price. A third set of changes concern various efforts to promote greater transparency and disclosure, as well as strengthen shareholders' rights through derivative suits in Japan or removing voting rights restrictions in Germany.

Greater differences are apparent when examining the issue of the board itself, since Germany and Japan have very different starting points. Japan has a unitary board of directors with only minimal legal distinctions between inside and outside members or between management and monitoring functions,

such as the system of statutory auditors. Meanwhile, German law is a key example of a two-tier board system that developed strong distinctions between the roles of the management board and the Supervisory Board, as well as having a long tradition of outside members of the Supervisory Board that represent various stakeholder groups including banks, large blockholders and employees. As a result, greater continuity can be observed in Germany and potentially greater change in Japan.

Germany has retained its board system that separates management and monitoring functions into two-tiers. However, several innovations were introduced by a 1998 corporate law reform to better define monitoring functions and promote greater use of committees in the Supervisory Board. A number of normative prescriptions of best practice were codified in the recent German Code of Corporate Governance in 2003 and enforced on a soft-law comply-or-explain basis (Cromme 2005). The principles of "comply or explain" in the new German Code were inspired by the Combined Code in the UK. Thus, while Germany remains distinctive in having a two-tier board structure and employee codetermination, the roles and functions of non-executive board members board have arguably become similar to practices elsewhere in the world. Several changes in corporate law have reinforced this trend by trying to improve the flow of information and further clarifying the responsibilities of various board members.

Unlike Germany, Japan has not experimented thus far with voluntary codes of corporate governance. Nonetheless, legal reforms aim to strengthen the external monitoring functions within the board. Whereas the two-tiered structure in Germany has remained remarkably stable, Japanese boards lacked a strongly developed parallel to this two-tiered structure. Japan has faced a greater need to rethink its basic approach to the board of directors. The traditional Japanese system has a rather unique position of the statutory auditor, who attends the board meetings and serves as a potential counterweight within the board. Historically, the role of the statutory auditor has been minor and even purely symbolic, since the auditors were usually former employees lacking any independence or strong external professional standards. Japan has now passed various measures to strengthen the independence of the statutory auditors. Perhaps more radically, the centrepiece of reform was the introduction of the committee system that allows firms to adopt a "U.S.-style" board system that uses committees with a majority of outside directors. These committees are for nominations, compensation and auditing. In the first year of implementation, just 43 companies (around 3% of First Section listed firms) have adopted this system (Seki 2005). However, more generally the number of outside directors and use of board committees has been very gradually increasing (Miyajima 2005).

Corporate Governance and Banks

Germany and Japan are both prime cases of bank-based systems of finance. Banks traditionally involved long-term and complex relations with industrial

firms based on credit, large equity stakes, financial services and advice, representing shareholders as a delegated monitor or through proxy votes, holding seats on corporate boards, and being active in corporate rescues (Aoki & Patrick 1994). Financial liberalization is widely perceived to have eroded rents from relational contracting. Market-oriented reforms have reduced advantages of private information underpinning relational contracting by increasing public disclosure and transparency. Liberalization also eased corporations' access to external capital markets and increased competition among financial intermediaries.

German private banks have shifted away from industrial loans and deposits, and toward highly profitable investment banking services (Deeg 1999). As large firms have become increasingly self-financing or look to international equity markets, banks have sought to diversify from lending activities that generate interest-based income to other types of fee-based income. Deutsche Bank and Dresdner Bank acquired British and U.S. investment banks, shifted their equity holdings to subsidiary companies, and divested from some large stakes. Banks are diversifying their ties to large firms. While high taxes previously hindered sales of large stakes, tax reforms initiated by the Social Democratic Party (SPD) make capital gains tax-free in 2002. Banks are also slowly reducing their supervisory board seats: private banks held 20 percent of seats in the largest 100 companies during 1974, but only 8 percent in 1986 and 6 percent in 1993 (Sherman & Kaen 1997, p.11-16). The example of Deutsche Bank, in particular, shows that the role of these private banks in corporate governance is diminishing (Hackethal et al. 2005).

These changes reflect growing dilemmas in maintaining traditional bank-firm relationships within a more market-oriented financial environment. This is well illustrated through the takeover of Hoesch by Krupp in 1991-92, and the merger of HoeschKrupp and Thyssen in 1997. Krupp's house bank (WestLB) informally supported Krupp's takeover attempt through its 12 percent stake in Hoesch. Likewise, Deutsche Bank failed to defend Hoesch despite its role as Hoesch's house bank and its seat chairing Hoesch's supervisory board. Deutsche Bank was again active in advising Krupp-Hoesch in its unfriendly takeover bid for Thyssen, while its management held a seat in the target's supervisory board. The implied conflicts of interest drew sharp public criticism and protest from the metal workers' union, IG Metall.

Despite these important changes and the attempts to modernise the financial system and promote the "New Economy," Germany still remains a bank-centred financial system with an underdeveloped capital market (Vitols 2004, 2005). Stock market capitalisation remains far behind in liberal market economies like the U.S. or the U.K., as do the number of IPOs. The company sector also shows a strong demand for bank-finance, thus underpinning the continued importance of banks in the corporate governance arena. This continuity is the result of institutional factors often ignored in recent debates (Vitols 2005). German households have only a very limited demand for

purchasing equity finance. Given the comparatively low degree of income inequality in Germany, the large group of middle-income households have a greater preference for less risky assets such as bank deposits.[6] Germany has only very limited private pension provision, despite recent reforms. On the company side, demand for equity finance also remains limited. The large sector of SMEs in Germany often specializes in lower risk technologies supporting Germany's competitive industrial infrastructure, and thus sustains demand for more traditional forms of bank finance. Thus, the distinctive characteristics of bank-based financial systems are not merely the product of regulation, but sustained by the complementary institutions that govern household income and investment, as well as industrial organization.

Turning to Japan, the financial and corporate governance role of Japanese banks has also changed dramatically (Aoki et al. 2005). Japanese main bank relationships were dramatically weakened as a consequence of the bubble. Financial liberalization gave corporations greater access to bond markets and rising share prices led to cheap equity finance – consequently reducing the demand for bank credit by large corporations. Banks initially compensated by lending to smaller and riskier firms, which later resulted in a huge volume of bad loans and unrealized losses on stocks purchased at the height of the bubble. As this banking crisis unfolded, banks reduced outstanding loans to meet capital adequacy ratios and created a credit crunch for smaller firms despite the Bank of Japan's zero interest rate policy. Banks also divested from shares or sold and repurchased holdings in order to improve balance sheets by booking unrealized gains. The introduction of market-based accounting has further reinforced equity divestment.

However, the weakening of bank-firm relationships does not hold true for all firms. Only larger and successful firms have been able to shift toward capital market finance. Meanwhile, firms with low growth prospect or young firms still depend on the banks to finance their investments, and have even become more dependent on bank loans over the 1990s (Miyajima & Arikawa 2005). Meanwhile, the accumulation of non-performing loans and indecisive government policies regarding the 1990's banking crisis led to a paradoxical situation. Potentially worthy firms faced a growing credit crunch, as banks were unable to offer new loans. Yet Japanese banks are argued to bailout bankrupt firms by ever-greening old loans to so-called "zombie" firms. However, this short-term rolling over of loans is correct only in firms where the concentration of main bank loans is very high (Miyajima & Arikawa 2005). The higher concentration of bank loans to firms with poor performance gives stronger incentives to main banks not to push client firms to restructure, since banks must avoid their own capital shortage. These facts suggest that relationship banking lost its positive function (bright side) in the 1990s.

6. High-income households have a greater preference for risky equity investment. Thus, a greater inequality in the share of national income going to top households will shift aggregate demand for equity.

However, most experts do not predict the demise of the Japanese main bank system, but focus on the need to restructure the banking sector itself (Aoki et al. 2005). Relational banking is being partially reconstituted with a focus on securities underwriting and risk management, rather than credit. Recent banking mergers[7] may help recapture scale and informational advantages, as well as eliminate excess competition. Policy measures to reduce bad loans are leading to slow reduction of debt. Meanwhile, new private equity investment is increasingly playing an important role in the corporate restructuring process, complementary to the main bank bail out mechanism, and bankruptcy procedures are well arranged under the recent regulatory reform. All these reforms may contribute to revitalizing banks and their monitoring capabilities, which, in turn, will make the threat of termination of client firms credible.

In sum, bank-firm relationships in Germany and Japan display both continuity and change. Erosion has occurred among the largest blue-chip firms in both Germany and Japan, weakening the major external corporate governance role of banks. However, the result of weakened bank monitoring is not necessarily increased power of other shareholders. One result may, in fact, be the increased autonomy of management and separation of ownership and control (Hackethal et al. 2005). At the same time, however, other segments of firms continue to have very strong relationships with banks. Relationship banking has not diminished completely, but has shifted towards different groups of firms. While banks are unlikely to regain their past monitoring capacity with regard to large capital market-oriented firms, they are likely to play a unique and important governance role among smaller credit-oriented firms.

Corporate Governance and Foreign Investors

In both Germany and Japan, the proportion of share ownership by large blockholders or long-term stable shareholders has moderately declined. The change is more pronounced in Japan, in terms of the levels of cross-shareholding. Cross-shareholding developed historically as a protection against hostile takeovers and to underwrite long-term business relationships. But sales of cross-shareholdings have been driven by the banking crisis (see Section 3.3) and greater volatility of balance sheets under new market-oriented accounting rules. Changes in corporate ownership have been similar but less pronounced in Germany, with greater continuity in terms of family ownership or pyramidal corporate groupings that are uncommon in Japan.

As bank and inter-corporate ownership declines, foreign investors now account for a growing proportion of share ownership and stock market transactions. While some of these investors include large FDI investments, the bulk of foreign ownership is portfolio investments undertaken by institutional investors from the US or UK, who seek greater risk diversification through overseas stocks. Given the volume of these holdings, the decisions of foreign

7. The major mergers follow: (1) Industrial Bank of Japan, Dai-ichi Kangyo Bank, and Fuji Bank; (2) Sumitomo Bank and Sakura Bank; (3) Sanwa Bank, Tokai Bank, and Asahi Bank, and (4) Bank of Tokyo-Mitsubishi and Mitsubishi Trust and Banking.

investors of whether to buy or sale shares has a huge impact on share prices, and it is often domestic investors who follow the lead of foreign investors when shifting portfolios.

Foreign investors also influence management through voice, particularly informal dialogue. Large institutional investors have some capacity to make their voices heard, by maintaining active relationships with firms. Domestic pension funds in Japan have also become more interested in exercising voice in corporate governance, as reflected in the surprising increase of “no” votes cast at shareholders’ meetings (Seki 2005). German and Japanese firms have responded by increasingly creating dedicated investor relations departments and engage in road shows and presentations for analysts.

Recent studies in Japan have documented a strong relationship between the percentage of shares owned by foreigners and corporate behaviour (Ahmadjian 2005). First, firms with higher foreign ownership are more likely to implement a variety of corporate governance reforms. Firms are especially more likely to increase transparency and information disclosure to outsiders, but also were more likely to engage in reform of the board of directors. Second, foreign ownership also had a positive impact on employment adjustment, specifically on the likelihood of reducing employment levels or reducing seniority-related pay (Ahmadjian & Robinson 2001, Jackson 2005c). Similarly, firms with higher foreign ownership were more likely to divest from existing assets. Therefore a positive relationship exists between foreign ownership and the degree of corporate restructuring.

Foreigners invest in only a very selective part of the overall stock market. Institutional investors such as pension funds tend to only invest in large, blue chip firms that are well known internationally and export to foreign markets. A key issue for investors is whether a firm’s shares have sufficient liquidity to facilitate easy busy and selling of large stakes. Even if foreign investors matter, they don’t matter for all firms. And even where foreign investment is high, shareholder activism by foreign investors faces serious limits. For example, coordination problems still exist for various institutional investors to jointly target pressure on particular company policies or poor management. Voting at shareholder meetings may be sporadic. And low level of commitment to particular firms means that investors will ultimately favour exit beyond some threshold of performance.

A major remaining issue concerns hostile takeovers. Changes in the composition of shareholding and (to some extent) the attitudes of investors may increase the prospect of a market for corporate control in Germany and Japan. Foreign investors are much more likely to support hostile bids that bring share price premiums, as seen in the case of Mannesmann in Germany (Höpner & Jackson 2001). To the degree that large firms become exposed to a serious threat of takeover, serious changes in corporate behaviour are likely to follow.

Corporate Governance and Employees as Stakeholders

The fact that employees have a strong voice in corporate governance has not, in itself, prevented corporate governance reform. Greater checks and balances and better information may enhance the prospects for voice by both investors and employees. Thus, Japanese unions and German works councils have supported at least some reforms. In Japanese firms exposed to capital market pressure, strong employee participation via labour-management councils had no positive or negative influence on adopting stronger information disclosure and shareholder rights, and had even a positive effect on board reforms (Miyajima 2005). The Japanese union federation, Rengo, also advocates greater disclosure on issues such as executive pay, and better disclosure of pension liabilities. Likewise, German works council members favour greater information disclosure and involvement of the Supervisory Board (Höpner 2001).

In economic terms, strategic or institutional complementarities have been posited between human-resource-management and corporate governance (see Gospel in this report).[8] New shareholder groups and regulatory reforms favour the diffusion of a shareholder-value paradigm of corporate management. As a criterion of business rationality, shareholder value runs contrary to the participation rights and sharing of organizational rents. How have changes in the role of capital markets impacted long-term employment and stakeholder-oriented nature of corporate governance in Germany and Japan? The next section reviews existing evidence on this question.

3.5 The Impact of Reform on Labour Management

This section compares various empirical results about the impact of corporate governance reform and associated shifts toward shareholder-value strategies on labour management drawing on my own work, as well as various studies conducted at the Max-Planck-Institute for the Study of Societies in Germany (Jackson 2004, 2005c, Jackson et al. 2005). The Germany-Japan comparison is focused on four issues: changes in the distribution of value-added, employment security and adjustment, pay systems, and employee voice.

The Distribution of Value-Added

Changes in the distribution of value-added between employees and investors are an imperfect, but potentially very interesting proxy of redistribution of wealth among stakeholders (De Jong 1996). In Germany, Beyer and Hassel (Beyer & Hassel 2002) first examined the distribution of net value-added among stakeholders. They found that high ownership dispersion positively influenced the share of dividends, but ownership had no direct impact on

8. Abe and Hoshi (Abe & Hoshi 2005) consider four possible combinations of financial system and human-resource-management system were examined: (1) bank financing and in-house training, (2) stock-market financing and in-house training, (3) bank financing and outsider training, (4) stock-market financing and outside training. Their model posits complementarity between bank financing and in-house training on the one hand, and between stock-market financing and outside training on the other.

the labour share. However, the adoption of shareholder-value[9] practices was associated with increasing share of dividends and a lower share for labour. The decline in labour share was largely due to a decrease in total employment through corporate restructuring. However, despite the shrinking labour share, compensation for remaining employees increased on average.

The Development Bank of Japan database was used to calculate a similar distribution of net value-added of listed Japanese firms. Unlike Germany, the median labour share rose from around 69% in 1990-93 to just over 79% in 2000-2002 (own calculations, but see also (Hyuga 2001). A similar shift can be seen comparing averages during two recession periods 1993-95 and 2001-2002. The median dividend share remained steady at around 2.9%. Japanese firms still favour policies of paying stable dividends as a fixed charge on revenue. Other studies show that Japanese firms cutting employment also cut dividends – very few firms redistributed wealth by reducing employment while raising dividends (Matsuura 2001). The increasing labour share resulted from lower interest payments as bank debt was repaid, as well as fewer taxes due to low profitability.

In sum, Germany appears to have undergone moderate redistributive pressures, perhaps indicating a greater push toward shareholder-value in Germany. Meanwhile, employees' distributive position has been more stable in Japan.

Employment Adjustment

Table 3.1 reports the rate of aggregate employment reductions of 10% or more in a single year across a number of advanced economies during the years 1991 to 2001.[10] The German data show the average and cumulative rates of employment reduction is only a bit lower than US levels and not significantly different from the overall sample mean. However, the US pattern is much more varied depending on economic circumstances. Whereas the 1991 rate is similar to Germany, the US rate in 2001 is twice as high. This data suggest that German firms do not avoid employment adjustment, but actually adjust gradually and steadily over a long period of time, despite strong employment protection law and participation rights of works councils.

9. The shareholder value index is based upon several dimensions including information disclosure, equity-oriented management incentives and the use of equity-oriented performance targets for business units (Höpner 2001).

10. Elsewhere I reported the results of a logit model predicting the likelihood of firms making a 10 per cent cut in employment across a pooled sample of firms across 22 OECD countries. After controlling for firm performance and industrial sector, significant country differences persist (Jackson 2005d).

Table 3.1:
Rates of employment reduction for selected countries, 1991–2001

Country	10% cut 2001	10% cut 1991	Average annual rate 1999-2001	Cumulative likelihood for each firm
Australia	.099	.057	.093	.301
Canada	.094	.212	.096	.312
France	.083	.079	.069**	.306
Germany	.093	.099	.101	.402
Italy	.147	.088	.096	.413
Japan	.059	.020	.041**	.213
Korea	.140	.104	.153**	.548
Netherlands	.070	.077	.065*	.351
Spain	.015	.122	.077	.292
Sweden	.154	.276	.095	.384
Switzerland	.131	.096	.091	.426
UK	.179	.164	.129**	.473
US	.206	.092	.106**	.445

Notes:
Sample covers listed corporations with over 2,000 employees. Reduction is counted as a negative shift in total employment of 10% over a one year period. Cumulative likelihood is calculated as the probability of each firm within the sample undergoing one or more employment cuts within the time period. N=33,094 firm-years.
* T-test for the difference of means with the pooled sample is significant at 0.05
** Significant at 0.01
Source: Own calculations from Thomson/Worldscope

In Japan, the cumulative rate of employment adjustment is by far the lowest among the selected countries. However, employment reduction increased three-fold between 1991 and 2001, putting Japan closer to some European countries but still far behind Germany. When controlling for company size and performance German firms were 56% as likely and Japanese firms only 32% as likely as US firms to cut employment by 10% or more in 2001 (Jackson 2005, pp.299).

As discussed above, German firms have reduced the labour share of value-added by reducing employment levels, but still paying higher wages to remaining workers. Employment adjustment is achieved largely through “benevolent” methods such as early retirement, rather than lay-offs. The German welfare state helps firms and works councils to externalise the costs of adjustment through state sponsored programs. However, this “externalisation” is placing increasing burdens on the welfare state, contributing to very high non-wage labour costs and unemployment (Streeck 1997). Divestment from business lines is another way of reducing employment. Here works councils may support the independence of core business, while using their influence to promote “good buyers” who offer employment prospects.

Large Japanese firms also reduced total employment but increased their average wages. The largest firms (based on the 99th percentile) had over 22,974 employees in 1993, but just 17,417 in 2002 (own calculations, DBJ database). At those same firms, average wage costs increased from just over 20 million to about 23.6 million yen per employee. Several studies show that corporate governance characteristics impact the propensity for employment adjustment. For example, foreign ownership increases the likelihood of downsizing (Ahmadjian & Robinson 2001). Meanwhile, strong ties to banks slowed or lessened the likelihood of reducing employment (Abe 2002, Matsuura 2001).

On the whole, Japanese firms remain committed to a modified form of employment security. Labour market data show that job retention rights show no major decline since the 1980s (Kato 2001). Recent surveys of top management express continued commitment of long-term employment policies by a vast majority of firms (Miyajima 2005). Strategies for employment adjustment in Japan thus continue to rely on intensifying transfers, hiring freezes and early retirement. Outright dismissals of domestic employees are usually avoided. According to a recent survey of listed firms, between 2000 and 2003, 36% of companies carried out employment adjustment, cutting their workforce by 15% on average (Jackson 2005a). The method of employment adjustment was overwhelmingly “benevolent”: 54% of reductions were by early retirement, 29% by hiring freeze, 5% by transfer, another 5% by spin-off, and only 4% through layoffs.

Given the continued legal supports, restructuring has often reinforced co-operation between management and unions in large firms. Legal protection of employment in Japan remains significant (Araki 2005). Protection is largely based on case law doctrines of the “abuse of the right to dismiss.” Recent court cases suggest some important loosening of the standards being applied to judge abuse. Yet the 2003 revision of the Labour Standards Law symbolically reaffirmed the case law doctrine as part of statutory law for the first time. Meanwhile, other recent legal changes have supported the participation of labour in restructuring. A key example is the Labour Contract Succession Law of 2000 to guarantee the transfer of employment conditions and collective agreements during mergers or spin-offs.

Employment adjustment in Germany and Japan thus seem to occur in ways consistent with a modified notion of stakeholder corporate governance. However, co-operative restructuring also has costs and limits for firms. The less developed Japanese welfare state means that firms cannot easily externalise the costs of adjustment. The benefits of transfers of employees to related companies may be diminishing as a result of corporate governance reforms that introduced consolidated accounting procedures. Japanese firms must internalise high adjustment costs, whereas in Germany the problem is more general as these costs place a burden on non-wage labour contributions to the welfare state.

Payment Systems

In Germany, shareholder-value management is strongly associated with adoption of performance-based pay schemes linking salaries to business and/or individual performance (Jackson et al. 2005). Normally wages in German are set by industry-wide collective bargaining that greatly constrain wage differentials between firms. Performance pay has not replaced these existing pay schemes, but come 'on-top' of rates set by centralized industry-level collective bargaining. This again reinforces co-operation among company "insiders." The new layer of pay schemes represents a controlled but de facto decentralization of collective bargaining. Consequently, strengthening such insider coalitions comes at some expense of solidarity across firms.

Japanese unions do not face the German problem of "equal pay for equal work" across firms under centralised collective agreements. A Ministry of Finance survey in 2002 identifies three types of pay systems – 50% of firms maintain traditional lifetime-employment and seniority pay, 29% utilise performance-based pay with lifetime employment and 16% utilise performance pay without lifetime employment (Miyajima 2005). For many firms, therefore, performance-based pay is being implemented in a context of stable internal career patterns, not as an alternative but a modernization of existing evaluation systems. This interpretation is also consistent with the fact that performance based pay in Japan thus far appears to be based on individual performance. Only 19% of firms surveyed by the Japan Productivity Center for Socio-Economic Development in 2000 used variable pay based on company performance (Jackson 2005a).

Employee Participation

In Germany, works councils often cooperate with corporate restructuring. On one hand, participation in restructuring involves works councils in the 'co-management' of important decisions and thus reinforces the co-operative character of German codetermination (Höpner 2001). On the other hand, codetermination is becoming less of an encompassing and solidaristic political and legal institution guaranteed by law. Rather, the contents and boundaries of codetermination are increasingly contractual. Works councils protect a shrinking core of "good jobs." Works councils thus face a latent conflict between core 'inside' employees and peripheral 'outside' employees whose interests are divided across weaker versus stronger business units.

Increased corporate restructuring also creates new problems for Japanese unions. Japanese enterprise unions lack legal rights for participation unlike in Germany. Participation depends upon informal social norms, as well as maintaining union strength through high membership. Japanese unions strength may depend upon defending the boundary of the firm or corporate group in order to internalize employment adjustment processes across various business units. Another difference is that the lack of German-style multi-employer wage agreements may mean that enterprise-based unions may

also be more willingly to accept direct or indirect forms of pay cuts in order to assure job security. Major firms such as Mitsubishi Materials and Kobe Steel implemented flat-rate cuts, while other firms such as NTT and Keio Electric Railway created new regional subsidiaries with lower wages.

3.6 Conclusions

What lessons can be drawn from comparing the German and Japanese cases? By way of conclusion, this report will highlight three sets of issues: The implications of recent change for international convergence, public policy and future research.

Convergence?

Much debate has surrounded the prospects for international convergence toward a single model of corporate governance systems. The cases of Germany and Japan suggest that strong convergence is not taking place. Continuities were pointed out such as differences in the structures of corporate boards, the continued weakness of capital markets, the importance of employees as stakeholders, the career patterns of top managers and corporate strategies based on long-term relationships. These features seem sufficient to argue that German and Japanese corporate governance remain quite distinct from their US or British counterparts.

These continuities should equally not obscure the fact that the changes underway in Germany and Japan are highly significant. Financial liberalization, the growing role of outside directors, the role of foreign investors and weaker relationships between large banks and large firms all suggest that popular understandings of the German and Japanese models must be revised. A challenging question remains for social scientists as to how to interpret the current balance of continuity and change (Streeck & Thelen 2005).

From the perspective of national corporate governance systems, current developments can be interpreted as a form of "hybridisation" (Jackson 2003). Structural elements of stakeholder-oriented models (e.g. employee codetermination) are being recombined with newer elements of shareholder-oriented models (e.g. transparency and disclosure) so as to arguably produce a distinct "hybrid" combination of structures and perhaps unique set of governance practices. It remains to be seen whether Germany and Japan will develop a more enlightened notion of shareholder value that balances shareholder and stakeholder interests, while providing sufficient corporate accountability.

In this regard, some authors describe the emergence augmented stakeholder coalition that now includes institutional investors, resulting in a kind of "negotiated shareholder value" in Germany (Vitols 2004). Here performance incentives for employees remain less strong than in the US or UK, thus perhaps representing a more egalitarian version of Anglo-American practices.

Moves toward greater shareholder value have not led to the exclusion of other stakeholders from corporate governance (Jackson 2003). Rather, cooperation among corporate insiders has, in some ways, increased. One might even speculate that moves to market-based forms of governance may have a potentially paradoxical result of weakening corporate accountability to the extent that the power of insiders is weakened, but not compensated by more active role of outsiders (Hackethal et al. 2005).

Another key consequence of hybridization is the growing heterogeneity of corporate governance across firms (Aoki et al. 2005). Corporations choose their corporate governance practices within the boundaries of prevailing national and international constraints. While national models were never entirely homogeneous, the capacity to generate relatively isomorphic practices across companies and sectors within a particular country is declining. Inherent institutional tensions, such as between public disclosure and relational contracting, facilitate deviant patterns of behavior (Whitley 1992, p.248) and greater firm-specific experimentation in combining elements of different models. Even if countries retain distinct "profiles" of corporate governance, the range of internal variation is growing particularly between large internationalized corporations and more protected domestically oriented or private corporations.

Policy Implications for Britain?

Can Britain learn from the cases of Germany and Japan? Here recent reforms broadly suggest the potential compatibility of stakeholder rights within corporate governance systems that are largely market-based and outsider-dominated. Greater checks and balances among stakeholders may even compensate for some of the inherent weaknesses of external, market-based forms of control. The main lesson of Enron was perhaps that external control is no substitute for good internal forms of corporate governance, based on the right sets of incentives, commitments and power sharing among stakeholders within the firm. While the stakeholder and shareholder models are often thought of us as alternatives, the practical realities in Germany and Japan are starting to blur these models. In this sense, Britain should take a keen interest on emerging best practices in these countries in the coming years.

More generally, corporate governance should not be approached as a one-size-fits all endeavor. Flexibility is important in allowing firms to mix and match different governance elements to suit their needs. A good example here is the resilience of bank-firm relationships among key segments of German and Japanese firms. Likewise, Japan has adopted an essentially British approach to board reform based on comply-or-explain principles. While few companies have actually adopted the new board system, this policy approach leaves much flexibility for experimentation in practice. The limit of this approach is that poorly performing firms in the most need of reform may face too little pressure to adopt reforms, unlike a mandatory regulatory approach. In this sense, other complementary governance elements are needed to pressure board reform.

Future Research Issues

While a large research agenda exists for specialists of German and Japanese corporate governance, this section will outline a few research areas that are particularly important from a British perspective.

First, the theoretical tools for understanding the phenomenon of “hybrids” are limited. Economics (unlike politics) assumes the necessity of a single objective function for firms (Jensen 2001), and that multiple objectives inevitably dilute accountability. However, recent sociological approaches suggest that opposing governance principles may be beneficial by placing checks and balances upon one another (Streeck & Thelen 2005). Hybrid regulatory or institutional “logics” may help maintain requisite variety across organizations, as firms work out these tensions through local experiments (Stark 2001). The application of sociological or political models of governance and accountability to private sector firms will be an interesting avenue for research.

Second, corporate governance needs to be studied in terms of configurations of elements. For individual firms, corporate governance involves different sets of practices that need to operate as a whole in order to be effective. Likewise, national models or regulatory frameworks for corporate governance have interrelated elements that need to perform complementary functions. Unfortunately, most of the empirical evidence base in corporate governance research has remained focused on more isolated sets of corporate governance practices, such as outside directors or legal rules for investor protection. The empirical results of such studies are often disappointing or even misleading, since the effects of these variables remains contingent on the presence or absence of other variables.

Recent methodological advances are starting to make possible the study of complex configurations of factors. Cross-national research or any research that deals with complex sets of interactions often face problems of where the number of explanatory combinations is greater than the number of observations, or where ‘limited diversity’ exists in the combinations of factors that can be observed. The techniques of qualitative comparative analysis (QCA) based on membership in fuzzy sets (Ragin 2000) are now starting to address these issues. QCA facilitates the analysis of whether a certain factor acts as a necessary condition for an outcome, or whether various combinations of factors are jointly sufficient conditions for particular outcomes. For example, discrete bundles of practices may be associated with higher firm performance, but a wide variety of bundles may be observed. This suggests that firms must engage in experimentation and search to learn and adapt practices given a variety of constraints. Recent empirical work has applied this configurational understanding to research the impact of corporate ownership and finance on employment outcomes (Jackson 2005d) or high performance work practices in the automobile industry (Kogut et al. 2004).

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4. Conference Session 4 Corporate Governance and Employee Voice

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4.1 Introduction

This paper brings together corporate governance and employee voice. Such a combination might seem strange in the UK, but not in some other countries. In Germany, for example, employees have a legally-based role in corporate governance, via codetermination rights on company boards and via the works council which has rights to information and consultation (Jackson et al 2004). In Japan, employees also have voice in the governance of firms, but based more on systems of internal promotion whereby board members are long-term, promoted company employees and based also on traditional notions of the enterprise as a stakeholder community (Araki 2004). In the UK, by contrast, both in practice and in the academic literature, corporate governance and employee voice tend not to be brought together.

Three arguments are posited for combining corporate governance and labour voice. First, as will be shown below, corporate governance can have profound effects on labour. Second, labour may have some effect on corporate governance – arguably it has had major effects in Germany and Japan, but even in the UK it could be argued there have been such effects. If these two arguments are correct, then this has analytical and policy implications. There is also a third argument, of a more moral kind: this is that labour *should* have a voice in corporate governance because it is a stakeholder in the enterprise. In turn, of course, this then prompts the question as to whether such participation will be beneficial or not for employees and for the firm.

The paper draws on two streams of research. The first part deals with the provision of information to employees. This section is UK-based, micro-level, and focused on the workplace. It uses data from the UK Workplace Employee Relations Survey (WERS) 1998. The second part is concerned with how corporate governance may affect broad labour outcomes in a number of areas. This section is macro-level, internationally comparative across countries, and focused on broad national systems of corporate governance and labour relations. It uses data from international sources, such as the World Bank, Stock Exchange Yearbooks, and the Organisation for Economic Cooperation and Development (OECD). From both sets of work we draw out implications for policy and for further research.

4.2 Corporate governance and employee voice: micro perspectives on information and consultation at work

This first part of the paper draws on a set of papers which have examined changing patterns of employee voice in general and information and consultation in particular (Gospel, Lockwood, and Willman, 2003a; Gospel and Willman 2003b; Peccei, Bewley, Gospel, and Willman 2005a; Gospel and Willman 2005; Peccei,. Bewley, Gospel, and Willman, 2005b).

There are various definitions of corporate governance, but in many of them information plays a key part. Hence, it could be argued corporate governance is about accountability and transparency and, therefore, information on the workings of the enterprise is important. Information is, of course, a source of power and asymmetrical information denotes disparities in power between participants in the firm. Transparency between managers and owners is invariably seen as a good thing in governance terms. But what about transparency between managers and employees? This is one of the questions which the body of research reported here has sought to answer.

The broad context in the UK is one of changing patterns of employee voice. It is well known that over the last quarter century, there have been a number of significant changes in employee representation at work: a decline in trade union density, especially in the private sector; a shrinking of the coverage of collective bargaining; and a growth in indirect forms of employee voice, based more on participation via direct workforce meetings, briefing groups, problem-solving circles etc. (Millward et al. 2000).

Two other aspects of employee voice at work are less well-known. First, information provision by managers to their employees seems to have risen over time, though it varies significantly between workplaces. Second, joint consultation at work has not declined in the way collective bargaining has shrunk and it has even increased in the private sector (Gospel and Willman 2003b). In addition, there is now a significant new development in the UK. With the passage of the EU Directive on Information and Consultation (2002/14/EC) and its transposition into UK law via the Information and Consultation of Employees Regulations (2005), there now exists for the first time in the UK the possibility of the extension of legally-based information and consultation procedures, along continental lines.

So what information do managements provide to their employees and with what consequences?

Survey evidence suggests that the pattern of information provision is polarized, with around 40 per cent of workplaces providing information over a wide range of topics, 20 per cent providing no information on the same range of topics, and 40 per cent coming somewhere in between, providing middle levels of information on some matters but not others. Information sharing is

highest in the public sector and, in the private sector, in larger workplaces and those with recognised trade unions (Cully, Woodland, O'Reilly, and Dix, 1999: 103-6, 231-2; Millward, Bryson, and Forth, 2000: 68-72). The work by Peccei, Bewley, Gospel, and Willman (2005b) also show that more information is provided in the following situations.

First, local managements provide more information where they actually have information. This is not a trivial point. Firms differ in the sophistication and quality of information they generate and this constrains the amount of information which is provided to employees at workplace level. Also, many local managers are not provided with information by higher level divisional and corporate managers and therefore cannot be expected to pass information on to employees. The stock of information is therefore important, and, the higher the stock, the higher the flow.

Second, managers provide more information where they say they trust employees and believe that their goals are aligned with those of the organisation. Again, this is perhaps not surprising, but again it is not trivial, not least because this may be a profound obstacle to general legal requirements to disclose information. In turn, this finding prompts the question of employee trust and commitment, and we return to this below.

Third, our analysis shows that managers are more likely to provide information in bad times rather than in good times. Thus, when the workplace is doing less well financially than its competitors or than in the past, management is more likely to disclose. This we have suggested is either part of a bargaining process to reduce employee claims or is an attempt to align employees' interests more with the firm.

Fourth, it has already been stated that more information is provided where there is a recognised trade union in the workplace. This may be either because the employer seeks to get the union 'on side' or it may be because the union is able to prise more information out of the employer. However, it would seem that almost the same amount of information is provided where there are extensive forms of direction participation in place. Least information is provided where there is only a joint consultative committee in the workplace. Moreover, adding mechanisms to one another (collective bargaining to joint consultation to direct participation) does not produce more transparency and more information for employees (Peccei, Bewley, Gospel, and Willman, 2005b).

But does greater information disclosure lead to superior performance, with benefits for employees and the firm?

This has been another major focus of the body of research on which this paper draws . In turn, this is built on two earlier literatures. One set of literature, in particular in Human Resource Management (HRM), has posited a universalistic argument, suggesting that voluntary provision of information by management

to employees can be expected to have a consistently positive impact on organisational performance (Pfeffer 1994; 1998). A second body of literature has posited a more contingent type argument, suggesting that the impact of information sharing on organisational outcomes may vary depending on the specific context involved, with the result that similar disclosure practices may generate different outcomes in different firms or workplaces (Kleiner and Bouillon 1988; Morishima 1991).

To explore these questions, three types of information were identified in WERS to provide our independent variables. These are the extent to which management provides information to employees on the following: (1) the overall financial and staffing position of the establishment; (2) more specific production, quality, and operational targets set at the establishment; and (3) feedback on the achievement of these targets. We refer to these three areas of disclosure respectively as general information provision, disclosure of performance targets, and disclosure of performance results/performance feedback. The three dimensions capture both higher level strategic type information and lower level operational type information.

Two main dependent variables were used in the analysis. These are the level of workplace labour productivity and product/service quality, both derived from the WERS 98 Management Questionnaire.

The main findings of the analysis are summarised in Table 4.1. The extent of disclosure varied considerably depending on the particular type of information involved. Thus, management provided information on performance targets in 82 per cent of establishments. However, it disclosed general information on financial and staffing issues and provided feedback on the achievement of targets in only 40 and 19 per cent of establishment respectively.

Table 4.1:
Information Disclosure. Schematic Summary of Regression Results

Independent variables	Intervening variable Organisational commitment	Dependent variable Labour productivity
Total sample		
General information		
Performance targets	+***	+**
Performance feedback		
Non union sample		
General information		
Performance targets	+**	+**
Performance feedback		
Union sample		
General information		+*
Performance targets	+*	+**
Performance feedback		
Strong union sample		
General information		+*
Performance targets		-*
Performance feedback		

Notes:
* t-value significant at 0.05
** t-value significant at 0.01
*** t-value significant at 0.001

The main effects of information disclosure are on labour productivity, rather than on quality. Hence we do not report the latter here, but note that only feedback on the achievement of targets has a significant impact on quality. Overall, the independent variable with the strongest positive effect on labour productivity was provision of information on performance targets, a more operational type of information. However, this worked mainly through its effect on employee organisational commitment which then in turn had a positive effect on performance. It was also moderated by the level of such commitment. Thus, performance feedback only tends to have a positive effect on labour productivity where levels of employee organisational commitment are high. Where commitment is low, performance feedback has little or no effect on productivity. In other words, the analysis suggests that the disclosure of operational results by management can have a beneficial effect on labour productivity, but that this is likely to be the case primarily in situations where there already is a reasonable degree of alignment between individual and organisational goals.

As part of the analysis, we divided the sample into union and non-union establishments. Two main points stand out from this analysis. First, the results for the sub-sample of non-union establishments are virtually the same as those for the sample as a whole. Second, the results for union establishments are generally weaker than those for non-union establishments. In other words, in union settings, the disclosure of performance targets by management had a smaller effect on organisational commitment and on labour productivity. For the union sub-sample, we also conducted a separate

analysis for establishments where unions were weak and where they were strong. In the latter case, the provision of information on targets had a direct effect on performance, but was negative. Of all the effects examined, only one was found to be stronger in union than in non-union establishments. This was the impact of general information disclosure on labour productivity. Thus, in union workplaces, management disclosure of general information to the workforce had a direct positive impact on productivity, while in non-union establishments the effect was not significant.

The findings have policy implications, for government, for firms, and for trade unions.

For policy makers, it must be remembered that, in the UK, there have historically been no general legal requirements for employers to disclose information such as discussed here. Particular episodes, such as redundancy or transfer of undertakings, may trigger disclosure of economic information to employees or their representatives. Collective bargaining may also trigger disclosure to trade unions, but under rather restrictive conditions (Gospel et al. 2003). However, the new Information and Consultation Regulations will introduce such a general requirement. Our findings indicate that the impact of such a general requirement is highly likely to vary, depending on existing conditions, specifically depending on existing levels of employee organisational commitment and on the presence and strength of trade unions. They also suggest that different forms of disclosure are likely to be more important in some contexts than others. Overall, disclosure of operational information on performance targets and outcomes is likely to yield greatest benefits to the firm, especially in non-union settings. But general information disclosure is also likely to be important and have a positive effect, especially in union settings. The implementation of broad legal requirements will need to take account of these factors.

An implication for management to be drawn from our findings may be that there is an optimal sequence to disclosure to employees. Disclosure of performance targets enhances organizational commitment and has a positive impact on productivity. To maximize the impact of disclosure, firms might wish to consider initiating disclosure on performance targets, then expand the disclosure agenda to include information on performance outcomes and wider organisational issues. It may be that there is an underlying learning model here for employees based on goal setting, establishing an appetite for firm performance information. However, in union settings, it may be as or more important for management to focus directly on disclosure of general information.

Likewise, for unions, the most obvious role is in terms of general information which they seem to have a greater capability to process than individual employees. Here disclosure can also have a positive impact on organizational performance. However, the findings suggest that there is scope for unions to

learn to play a positive role in the receipt of operational information which affects employee commitment and labour productivity.

Further research should seek to overcome the limitations of this study by using longitudinal data obtained form both management and employees. Ideally, researchers should use more detailed measures of disclosure, allowing for a more refined analysis of the effects of information-sharing on organisational performance. It would also be instructive to use objective, along with subjective, performance data, as has been done in previous US and Japanese research. Future research could also usefully extend the analysis to other performance outcomes and examine, for example, the impact of disclosure on the financial and market performance of organisations. Likewise, future research might also explore the impact of information disclosure on a range of HR, industrial relations, and employee-related outcomes, including, for example, levels of conflict/cooperation, satisfaction, and well-being at work. In addition, we need to gain a better understanding of the impact of information disclosure in different institutional contexts. In particular, it would be useful to consider a broader set of institutions, including consultative committees and direct participation methods, and to explore the information outcomes. Finally, it would be interesting to extend this work via international comparisons for which some basis already exists in US, Japanese, and German work (Kleiner and Bouillon 1988; Morishima 1991; Frick and Lehman 2005).

4.3 Corporate governance and labour outcomes: macro international perspectives

The second part of the paper draws on a very different stream of research concerned with broader aspects of corporate governance and labour outcomes. The work moves to the macro-level, is internationally comparative across countries, and focuses on national systems of corporate governance and labour relations (Gospel and Pendleton, 2000; Gospel and Pendleton 2003; Gospel and Pendleton 2004a; Gospel and Pendleton 2004b; Gospel and Pendleton 2004c; Jackson 2004; Black, Gospel and Pendleton 2005a; Black, Gospel, and Pendleton 2005b).

This research was in part prompted by and has drawn on a number of major typologies of corporate governance systems. In these it is suggested that there are two major clusters of national finance and corporate governance systems, constituting two main ‘varieties of capitalism’ (Franks and Mayer 1997; Allen and Gale, 2000; Dore, 2000; Hall and Soskice, 2001).

On the one hand, there are said to be market-outsider or liberal-market systems. These regimes have the following characteristics: for corporate financing, they make extensive use of equity markets and short term debt such as corporate bonds which are tradeable in the market; such countries have a large listed sector; they also have a high free float of shares and extensive secondary trading in shares. Under such regimes, it is often said that owners

are ‘impatient’, tend not to get involved in corporate management, and use the threat or reality of exit as instruments of corporate control. Such systems are also characterised by a high level of mergers and acquisitions (M&A) and this ‘market for corporate control’ provides a form of outsider governance or check over managers. A summary shorthand might be to say that such systems are concerned primarily with the maximisation of ‘shareholder value’. Such arrangements are said to be typical of Anglo-Saxon countries, especially the US and UK.

On the other hand, there are more relational-insider or coordinated-market systems. These regimes have the following characteristics: for financing, less resort is made to equity markets and short-term debt and more reliance is placed on longer-term borrowings from banks and from other firms; the listed sector is consequently smaller and there is a lower free float of shares and less secondary share trading. In addition, there are fewer M&As, an absence of hostile takeovers, and a less active market in corporate control. In these circumstances, governance takes more of an insider form and voice by big shareholders is used as an instrument of control. In popular parlance, these systems are said to be less shareholder value and more ‘stakeholder’ orientated. These arrangements have traditionally characterised economies such as Germany and Japan.

There is then a further series of arguments that these systems create a set of dynamics which influence labour arrangements. These dynamics flow from the balance of support given by managers to shareholder versus labour interests, the time-horizons of management decision-making, and the importance attached by managers to financial as opposed to other measures of performance. The theory which links finance, governance, and labour is outlined in Gospel and Pendleton (2003), but may be summarily stated as follows.

Market outsider systems generate the following employment characteristics. Strong financial market pressures lead to shorter average job tenures, as firms are more likely to lay-off workers during downturns and as workers in turn look to the external market in upturns. Firms are also likely to make more use of contingent employment, such as temporary and part-time workers, who have fewer claims on the firm and who can be more easily laid off during bad times. In part as a result of these factors, less training may be done in such systems, especially since returns on investment in human capital are difficult to measure and not valued by financial markets. Also, in these circumstance, there may then be less internal or functional flexibility within the firm: employees are less able or less willing to work flexibly and employers are less able to request such flexibility. In terms of pay, such marketised, outsider systems favour contingent pay arrangements, such as performance, profit, and share-based pay, which avoid fixed costs and are seen as the best way of incentivising employees. This may then have consequences for pay structures within the enterprise: senior managers may be able to secure high rewards for

themselves, but may in turn be under pressure to hold down the pay of lower level employees. If this is the case, pay differentials from top to bottom will be wide. Finally, and related to the first part of this paper, there may be consequences for employee voice regimes. Under these kinds of pressures, managers may be less willing to accept employee voice arrangements which constitute checks or claims on the firm, may prefer voice via arrangements such as shareownership schemes which seek to align workers interests with the firm, and may provide less information which they think employees will use to the disadvantage of the firm. Where collective bargaining with trade unions cannot be avoided, firms will seek to bargain at as low a level as possible, especially at workplace level, so as to obtain a swop-off of productivity increases for pay rises and so as to exclude unions from voice at corporate level.

By contrast, the literature suggests that relational insider systems are likely to lead to different employment outcomes. These include, for example, longer job tenures, less use of contingent employment, and a higher propensity to train. Accompanying this and to compensate for the absence of numerical flexibility, there may be more functional flexibility internally within the firm. In terms of pay, there might be less use of contingent pay systems and narrower pay dispersion in terms of wage structure. Also, in such systems, there might be a greater preparedness to accept employee voice within the firm and provide more information more willingly. Where collective bargaining exists, there is a possibility of bargaining at both decentralised plant and more centralised company levels.

In the edited collection by Gospel and Pendleton (2004), these relationships are explored by writers covering a number of countries – the UK, US, Germany, Netherlands, France, Italy, Spain, and Japan. The rich, detailed historical and institutional accounts reveal complex and mixed stories. Thus, there was some questioning of the two systems model. In particular, the Latin group of countries did not easily fit, with their interlocking ownership of large firms and state intervention, coupled with weak employee voice within the firm and a rather stronger role in centralized collective bargaining. Moreover, there is some change in the polar systems: thus, German and France are becoming less relational and the UK may be becoming more of an insider or quasi-insider system. Though the national studies suggest that corporate governance has affected national labour systems, especially when viewed longitudinally, they also suggest that labour systems can shape corporate governance, as evidenced by Germany and Japan. This was also seen in the Latin countries, especially France, but in a negative way viz. uncooperative labour was purposely excluded from governance and this facilitated the substantial restructuring of large French firms over the last two decades (Goyer and Hancke, 2004).

Notwithstanding these qualifications, this broad international overview of recent developments does show a move towards more Anglo-Saxon form of outsider corporate governance across a spread of countries. In turn, this is having an effect on labour systems, as seen in particular in the growth of contingent employment and contingent pay. In reviewing the national studies, Jackson (2004) concludes that, as marketised finance and governance extend, so it is difficult to maintain relational type employment systems.

More recently, work has also begun, using large OECD-type data sets, further to test these relationships across a wider spread of countries. Here we report work by Black, Gospel, and Pendleton (2000a and 2000b) which also provide reviews of other emerging literature.

In these multivariate models, independent variables are created for finance and corporate governance. Finance is captured by an index for each country made up of stock trading as a proportion of market capitalisation, plus new issues as a proportion of capitalisation, multiplied by the number of listed firms per million population. Corporate governance is captured by the level of M&A and is used to indicate the market for corporate control. In turn, M&As are expressed as the ratio of the number to population in millions, averaged over ten years. The following dependent variables capture labour outcomes: average job tenure; the speed and size of fluctuations in employment over the cycle; employee shareownership by manual workers; CEO pay as a multiple of average pay; and aggregate real wage flexibility viz the extent to which aggregate real wages adjust to unemployment.

In the research, it was also decided to compare these finance/governance explanations with more conventional accounts. The latter explanations relate to the following: labour market conditions as measured by the level of unemployment; product market competition as measured by the extent of product market regulation; government institutions comprising the replacement ratio (the ratio of unemployment benefit payments to average wages), active labour market policies, the strength of employment protection legislation, and the tax wedge; and labour market institutions as measured by union density, collective bargaining coverage, and union and employer bargaining co-ordination (providing an index heavily reflecting co-ordination).

The main results of one specification of the model are to be found in Table 4.2. This suggests the following. The finance and corporate governance variables worked well compared to the other main sets of explanations. However, finance worked better than corporate governance. In particular, in terms of employment outcomes, financial marketisation seems to be negatively associated with average job tenure and highly positively related to employment adjustment over the cycle. In terms of pay systems, financial marketisation is highly positively related to the use of contingent pay for manual employees and with wider pay dispersion between CEO pay and average pay. Our corporate governance variable was positively associated with

employment adjustment over the cycle; it was also associated with employee shareownership and CEO pay, but neither was statistically significant. Of our other variables, unemployment had a negative effect on average job tenure and a highly significant positive effect on employment adjustment over the cycle. Greater product market regulation would seem to lead to higher average job tenures, less use of employee shareownership, and less real wage flexibility. Finally less coordinated industrial relations institutions would seem to be associated with more employee shareownership, higher CEO pay to average pay, and higher real wage flexibility.

Table 4.2:
Finance, Corporate Governance, and Labour.
Schematic Summary of Regression Results

Independent variables	Dependent variable
	Tenure
Finance	-*
Corporate governance	
Labour market/unemployment	-*
Product market regulation	+**
Government Institutions	
Industrial Relations Institutions	
	Employment over the cycle
Finance	+***
Corporate governance	+
Labour market/unemployment	+***
Product market regulation	
Government Institutions	
Industrial Relations Institutions	
	Employee shareownership
Finance	+***
Corporate governance	
Labour market/unemployment	
Product market regulation	-*
Government Institutions	
Industrial Relations Institutions	+**
	CEO pay
Finance	+***
Corporate governance	
Labour market/unemployment	
Product market regulation	
Government Institutions	
Industrial Relations Institutions	+***
	Aggregate real wage flexibility
Finance	
Corporate governance	
Labour market/unemployment	
Product market regulation	-***
Government Institutions	+***
Industrial Relations Institutions	+*

Notes:
* t-value significant at 0.05
** t-value significant at 0.01
*** t-value significant at 0.001

In other specifications of the model not reported in Table 5.2, a number of further relationships may be noted. First, more marketised finance and outsider governance systems seem to be related to greater training. At first this seems puzzling, since the literature suggests the reverse (Gospel and Pendleton 2003). However, the measures of training relate to continuing vocational training. One explanation for a positive relationship might be as follows: if market-outsider systems make for less initial training by way of apprenticeship and other entry training, then there may indeed be more need for continuing training, especially if this is of a more firm specific kind. Second, in one specification of the model, we introduced the best measure of functional flexibility we could find for a spread of countries, viz the systematic use of job rotation within companies. This was found to be positively related to outsider corporate governance, contrary to expectation, but was not statistically significant. Third, overall, there is little support for the proposition that institutions of industrial relations practices are influenced by finance and governance regimes. By contrast the best explanations for aspects of worker voice seem to be other industrial relations phenomena, such the degree of employer and union coordination in the labour market and the centralization of collective bargaining.

Policy implications of this research are more for national level policy makers. They would suggest that a move towards more flexible employment systems may be as much, if not more, driven by finance and governance factors than by other sets of explanations, such as labour and product markets, government policy, and weakening industrial relations institutions. Countries which may wish to move towards more flexible labour arrangements might therefore well consider the promotion of more marketised finance and corporate governance. However, governments which may seek to promote more Anglo-Saxon type finance and governance, but which seek to maintain more coordinated and less marketised employment systems, will find it difficult to achieve both simultaneously.

Further research should seek to overcome the limitations of the studies referred to above by introducing time series data – however, this would significantly reduce the number of observations. It would also be useful to have other measures, especially for training and functional flexibility. A further area for research would be to use company level data, for example, drawn from Thompson Worldscope and other databases (Jackson 2005) – however, again this would significantly reduce the number of variables. A further exciting area of research would be to do similar work within the UK. Work on these lines has already been done in the US (Bronars and Deere, 1991; Hanka, 1997; Perotti and Spier, 1993; Sharpe, 1994). It has also been done in Germany (Jackson et al 2004; Frick and Lehman 2004). It has recently begun in the UK (Bacon and Berry 2005). Together this work suggests some links between financial structures/governance arrangements and labour outcomes, broadly on the lines suggested above. Finally, there is scope for more detailed case study work, bringing together quantitative and qualitative material, to examine

these relationships in individual firms. Among other advantages, this would offer the possibility of investigating how institutional investors view HRM.

4.4 Conclusions

This paper has attempted to bring together corporate governance and employee voice. It has done so by reviewing two streams of research. The first concerned the provision of information to employees. This is UK-orientated, micro-level, and focused on the workplace. The second concerned how corporate governance may affect certain labour outcomes. This is internationally comparative across countries, macro-level, and focused on broad national systems of corporate governance and labour relations. Both attempted to show how corporate governance can have profound effects on labour, but also how labour voice may have some effect on corporate governance and performance. There are policy implications here for various parties: for governments in terms of legislation on information and consultation for employees and on the effects of marketisation in one area on marketisation in another; for managements who might wish to consider the effects of more or less employee voice in corporate governance; and for trade unions and other employee bodies as they seek to adjust to changing financial and governance arrangements. As indicated, there are wide possibilities for further research bringing together corporate governance and employee voice.

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5. Conference Session 5 Human Resource Management and Corporate Performance: Recent Empirical Evidence

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5.1 Introduction: Human Resource Management and Corporate Governance.

Debates about corporate governance have included consideration about whether a well-run and effectively governed company is also likely to be a high performing and financially successful company. In parallel with this debate, there has been a similar concern about whether the good employer is also likely to be a financially successful employer. The focus on the company as an employer provided the basis for the DTI-sponsored Kingsmill Report (2003) Accounting for People which asserts that "the way organisations manage their people affects their performance". Many would go further than this and support the cliché that "our people are our most important asset". More pragmatically, American writers on business strategy such as Barney (Barney, 1991; Barney and Wright, 1998) would argue that the effective management of human resources provides the key basis for gaining competitive advantage, mainly because it is likely to be embedded in the organisational culture and much less easy to imitate than other strategic initiatives. If this is the case, then it should be possible, through research, to show that the effective management of human resources does result in superior performance. This proposition has provided the basis for a growing body of research, some of which will be presented in this paper.

The Kingsmill Report used the term "human capital" and suggested that:

> "Human Capital Management – an approach to people management that treats it as a high level strategic issue and seeks systematically to analyse, measure and evaluate how people policies and practices create value – is winning recognition as a way of creating long-term sustainable performance in an increasingly competitive world" (op cit p.3)

Given this claim, the report recommended that relevant aspects of human capital performance should be incorporated into the Operating and Financial Review (OFR) proposed as part of the new company legislation.

The tone of the Kingsmill Report emphasised that effective management of human capital, or human resources, should be treated as a strategic board level issue and carefully monitored because of its impact on performance. This reflects the view of the shareholder as dominant stakeholder. From a broader stakeholder perspective, it can be argued that being a good employer is not only a means to the end of higher performance and strong financial returns but also an end in itself. This view can certainly be argued from the perspective of a body of social and employment legislation, much of it sponsored and overseen by the Department of Trade and Industry and designed to promote, inter alia, health and safety at work, equal employment opportunities and scope for communication, involvement and consultation. It therefore follows that the case for a governance role in ensuring good employment practice and effective management of human capital is that this is both an end in itself in ensuring the well-being and satisfaction of employees but also a means to an end of higher performance. In theory at least, every one wins.

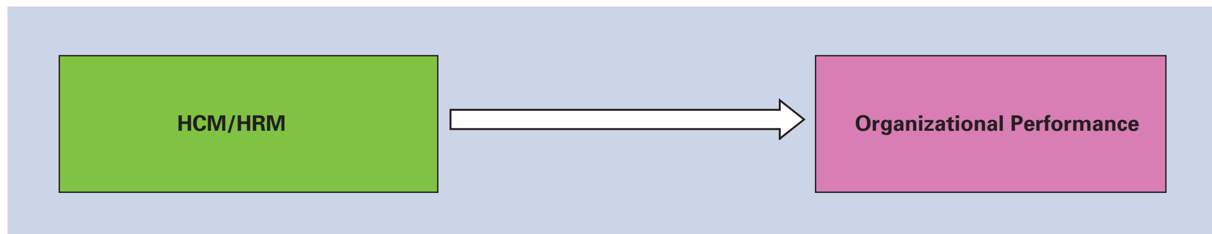
There are three main problems with the Kingsmill analysis, which are clearly signalled in the report. The first is that the quality of the evidence about the relationship between the effective management of human resources and corporate performance remains less than wholly convincing. We might add that there are those who also doubt whether human resource management results in any gains in employee well-being and satisfaction. Secondly, even if an association between human resource management and performance can be demonstrated, it is unclear how to apply this knowledge. More specifically, which human resource practices matter most and if a firm wants to take action, where should it start? Thirdly, if firm performance in its management of human capital is to be reported, what should be reported and how can it be interpreted? For example, what is a ‘good’ level of labour turnover? Is expenditure on training a good indicator of training quality? This problem resulted in Kingsmill making no recommendations on the specific content of any human capital report.

This paper explores the first and arguably the most important of these three issues. First it presents a conceptual framework; then it presents some British and comparative data; next it considers the views of those senior executives who have to determine whether the management of human resources should be treated as a strategic priority; finally, it offers some policy-related conclusions.

5.2 The Conceptual Framework

The core preliminary proposition, set out in Figure 5.1, is that engaging in more human resource management will result in superior firm or organisation performance.

Figure 5.1
The Basic Model



Three initial elaborations are required. We need a definition of human resource management, we need to determine the appropriate measure of performance and we need to understand how they are linked. The last point is important if we want to explain differing results and if we want to understand the policy implications of changing human resource management. All three issues have been extensively discussed in the academic literature.

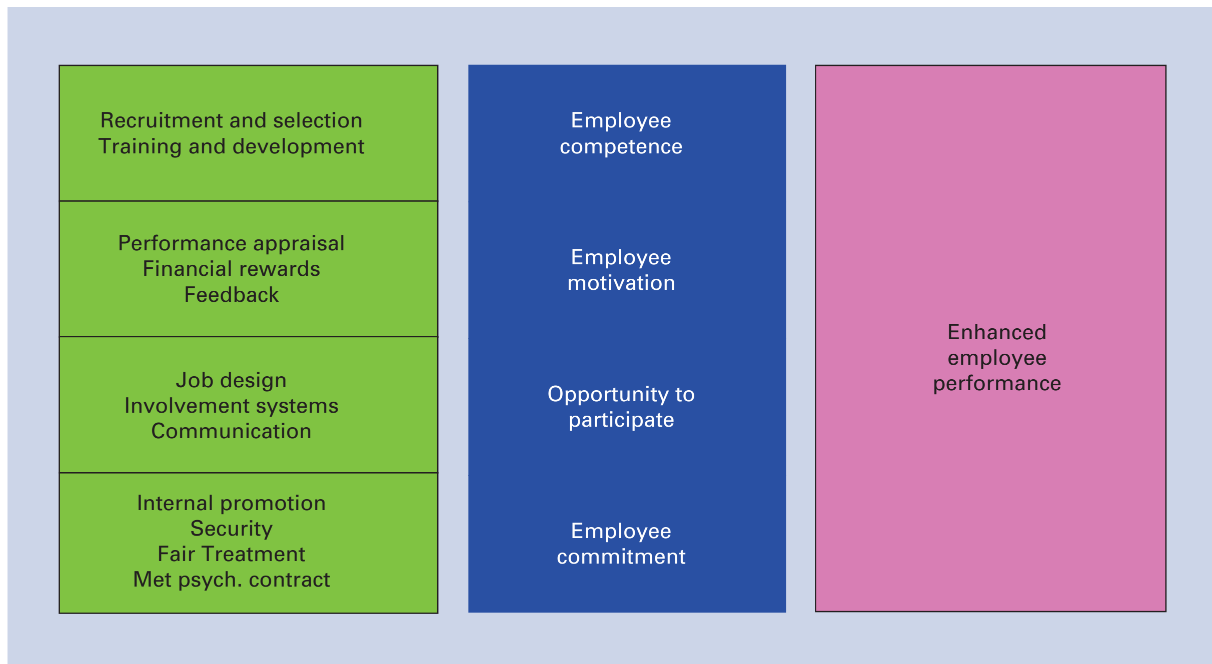
Two key and somewhat inter-related features of contemporary views about human resource management deserve special attention. The first is the notion of strategic integration or fit. Put simply, this suggests that it is essential for human resource management strategy to be integrated with the business strategy of the firm to ensure complementarities. However it also suggests that the various human resource practices must fit together and complement each other. The second key feature is the notion of human resource management as a system (Becker and Huselid, 1998). It is not enough to focus on and ensure very high quality selection or appraisal or reward systems. The concern should be less with specific practices and more with sets or what are sometimes described (e.g. MacDuffie, 1985) as bundles of practices.

Advocacy of a strategic fit between business strategy and human resource strategy leads logically to a contingency view in which the appropriate human resource strategy and practices will be determined by, and differ according to the nature of the business strategy (Schuler, and Jackson, 1987). In a counter to this, some mainly American writers (e.g. Walton, 1985; Pfeffer, 1998) have argued that in the contemporary world of work, taking account of the need for organisational flexibility and innovation as well as the changing expectations of the workforce, a distinctive set of human resource practices designed to elicit high performance and possibly high commitment will invariably result in superior performance to the alternatives. Despite the powerful logic behind the contingency approach, the empirical evidence has not yet been able to resolve this debate. If anything, it leans towards the more universalist model.

In terms of trying to understand both the practices that need to be covered in effective human resource management and why they might have an impact, there is an emerging consensus around the model presented in Figure 5.2. This proposes that high employee performance will be determined by the competence, motivation, opportunity to contribute and commitment of employees. These in turn will be determined, at least in part, by the presence of an appropriate set of human resource practices, illustrated on the left hand side of Figure 5.2. Competence is likely to result from effective selection, training and development practices. Motivation is likely to be associated with effective application of aspects of performance management as well as providing challenging roles and goals. Practices designed to provide communication, consultation, participation and a degree of job autonomy will enhance the opportunity to contribute. Finally, commitment is likely to be enhanced by met expectations, reasonable employment security, fairness of treatment and high levels of trust, all suggesting that the psychological contract is being met.

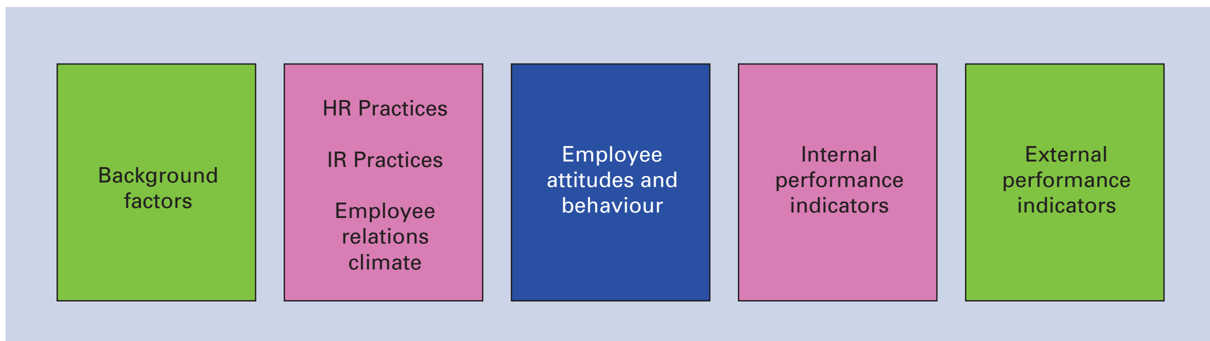
The 'systems' dimension of human resource management is reflected in the underlying theory of employee performance which suggests that if any one of the elements of competence, motivation and opportunity to contribute is missing, performance is likely to suffer. American models tend to underplay the commitment dimension and describe a high performance rather than a high commitment model (see, for example, Appelbaum et al, 2000). However in the European context, there is likely to be more emphasis on issues associated with fairness and trust; and commitment is often associated with lower labour turnover and sometimes with higher 'engagement' activities (Meyer and Allen, 1997). We will therefore use this framework as a starting point to classify and bundle human resource practices. In doing so, it should be noted that some substitutability within each cluster is possible, for example between use of selection and training, and some redundancy may be built in and may even be desirable to reinforce behaviour. In practice, however, most research has used what amounts to an additive model, counting the number of high commitment or high performance practices in place.

Figure 5.2
High Commitment HRM



The model in Figure 5.2 does not effectively address performance. It is possible to conceive of a range of measures of performance that are closer to or more distant from the human resource practices. Among the more proximal measures are absence, labour turnover and less easily captured outcomes such as offering suggestions, voluntary overtime and compliance with change. Moving slightly further away, there are measures of quality such as scrap rates, customer complaints, errors and inspection targets as well as measures of labour productivity. Finally there are measures that are more external to the organisation and farthest removed from the human resource practices such as sales, profit, return on assets, share price and a range of financial indicators. All of these have been used in reported research. The model in Figure 5.2 can be extended to include these. Figure 5.3 suggests how this might operate. The implication is that there should be a stronger association between human resource management and the proximal measures and that this relationship should decrease as the measures become further removed from any direct influence of human resource practices. Therefore any association between human resource management and the most distal measures, such as company profits might be quite small but is also a powerful indicator of that association. Nevertheless, much of the research has been particularly concerned to explore the relation between human resource management and corporate performance.

Figure 5.3
Linking HRM and Performance



5.3 The Research Evidence

There is a growing body of mainly American research, accumulated over the past fifteen years, that has explored the relationship between human resource management and firm performance. This includes research linking use of a greater number of human resource practices to outcomes such as labour turnover (Huselid, 1995), scrap rates (Arthur, 1994; Ichniowski, Shaw and Prennushi, 1997), productivity (Huselid, 1995; Arthur, 1994; Ichniowski et al, 1997; MacDuffie, 1995), quality (Arthur, 1994; MacDuffie, 1995) and Tobin's Q (Huselid, 1995). Although these studies tend to use rather different measures of human resource practices (see Becker and Gerhart, 1996 for a discussion of this), all conclude that there is a positive association. Although the amount of variance explained is often quite small, Huselid in particular argues that the size effects are large and should capture the attention of any responsible company board.

There is much less evidence available outside the USA, including Britain. One of the best known UK studies (Patterson et al, 1997), based on longitudinal data and testing something closer to the model in Figure 5.2, found an association between human resource management and changes in both productivity and financial performance. Furthermore, they claimed that it accounted for more of the change in performance than other potential influences such as spend on R&D or investment in technology. However the sample was a small number of single site manufacturing organisations. Thompson (2000) has explored human resource management and performance in the aerospace sector and reported a clear association between them. More recently, using NHS Trusts as the context, West et al (2002) reported an association between a small set of practices and lower death rates. However the sample was again very small and the choice of HR practices was unusual. Using a larger but slightly older sample of 110 NHS Trusts, Peccei, Guest and Dewe (2002) found that those Trusts applying only a small number of HR practices had significantly lower productivity and quality and higher unit labour costs than other Trusts; but beyond a certain point, there appeared to be few benefits in adding more HR practices. It is in this context of very limited information that the data below, based on a research project funded by the

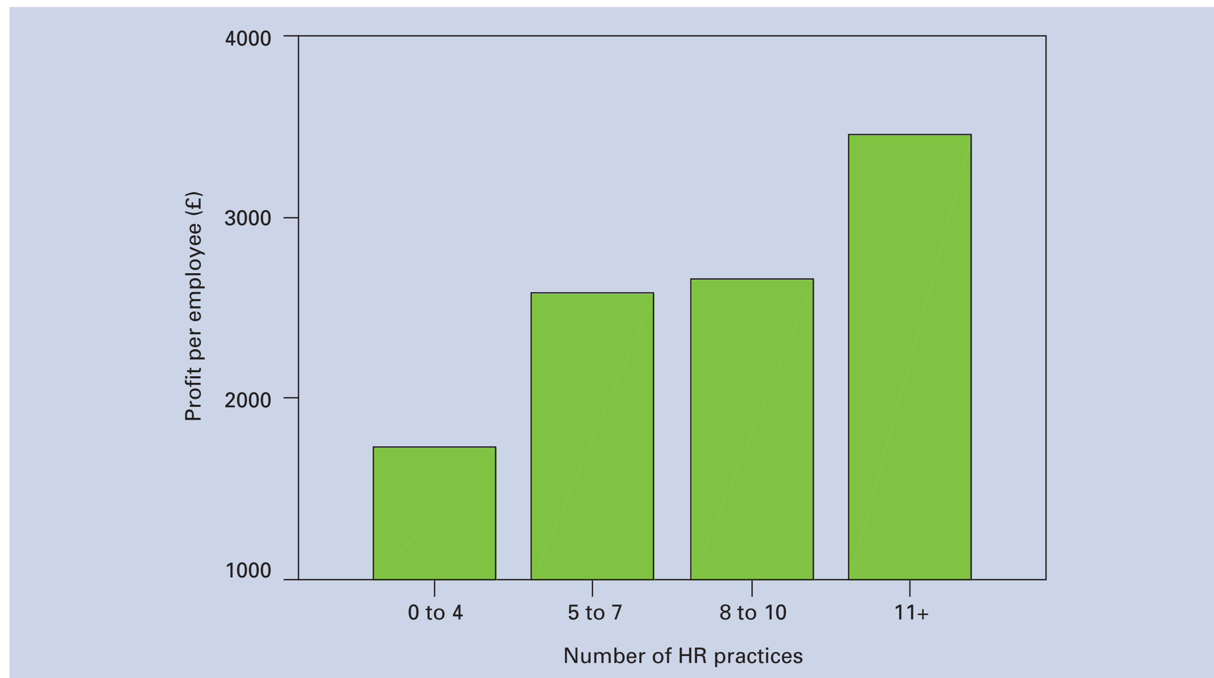
ESRC[1] with additional support from the Chartered Institute of Personnel and Development, are reported. This study is currently the largest company-level study in the UK.

The research was initially conducted in the UK and later extended, on a somewhat smaller scale, to Australia and New Zealand. The UK component consisted of surveys of human resource directors and chief executives in a number of companies drawn from the Dun and Bradstreet data base. Their responses to questions about strategy and human resource practices were matched to financial data over a number of years both before and after the survey data were collected. We also collected information about a number of other outcomes including labour turnover. The core sample consisted of 610 HR directors or the most senior person responsible for HR policy and practice and 462 chief executives or, where that person was unavailable, their nearest deputy. There were 237 organisations where data were collected from both managers. In addition, there were a number of detailed case studies, although these will not be described here. Financial data over more than one year was available from only 297 of the organisations.

The first key question concerns the relationship between human resource management and performance. Human resource management was measured using 48 items that clustered into nine main topics such as recruitment and selection, training and development, pay and rewards, communication and consultation and job design. Scores on each topic were standardised and then added to provide a possible range from 0 to 18 practices. The key outcomes we report below are financial performance for the year after the data on HR practices were collected and labour turnover based on the most recent year for which data were available. The financial results are presented as profit per employee, since this appears to be a simple way of accommodating the human dimension while taking some account of size. The results are presented in simplified form in Figure 5.4.

1 This research was funded under grant L212252040 of the ESRC Future of Work programme. I would like to acknowledge the support of the ESRC and also the Chartered Institute of Personnel and Development.

Figure 5.4
HR and profit per employee (UK)

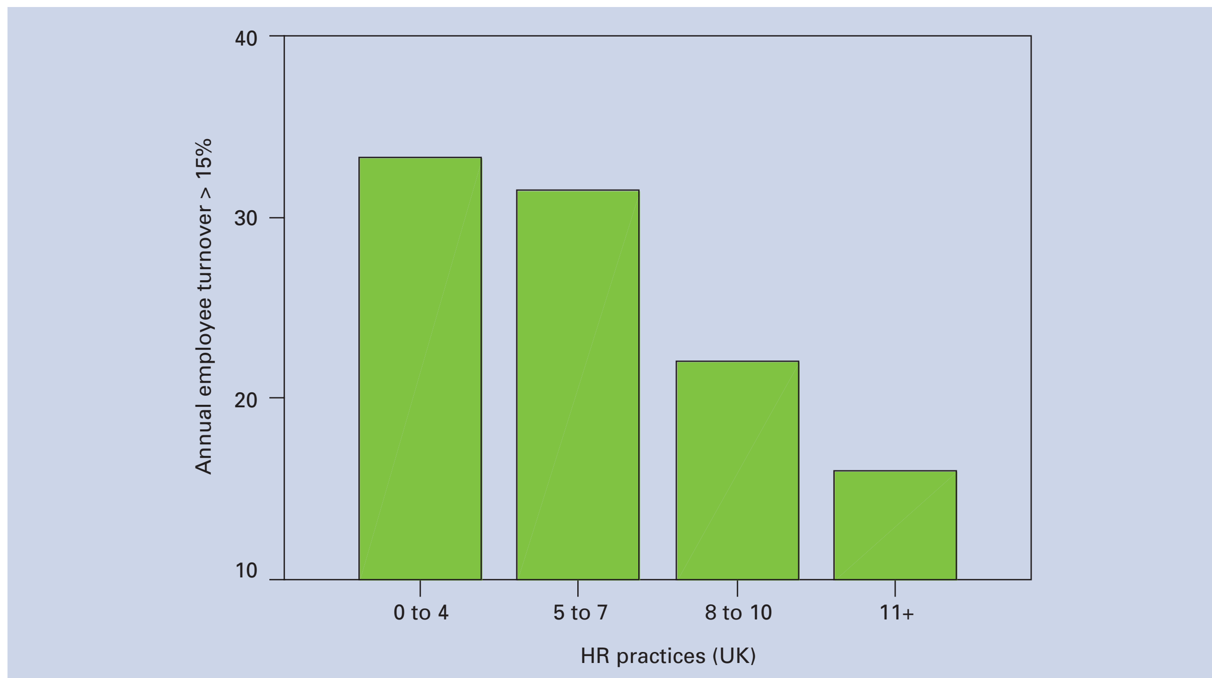


Source: FoW (N=297)

The results show a straightforward association between the number of human resource practices in place in 1999 and profit per employee in 2000-2001. This association remains significant once standard control variables have been included in a regression analysis (see Guest et al, 2003). The regressions also reveal that the results are much stronger in the manufacturing than in the service sector. Indeed, if we look at the service sector alone, they fall short of statistical significance. Furthermore, if we adopt a more rigorous test and control for prior performance, then the associations for the sample as a whole cease to be significant. This implies that although there is an association, we cannot disentangle whether greater use of human resource practices led to higher performance or vice versa. Indeed, this conundrum is probably unresolvable in a study of this sort, since we cannot know when the human resource practices were introduced and whether or not they had already affected prior performance.

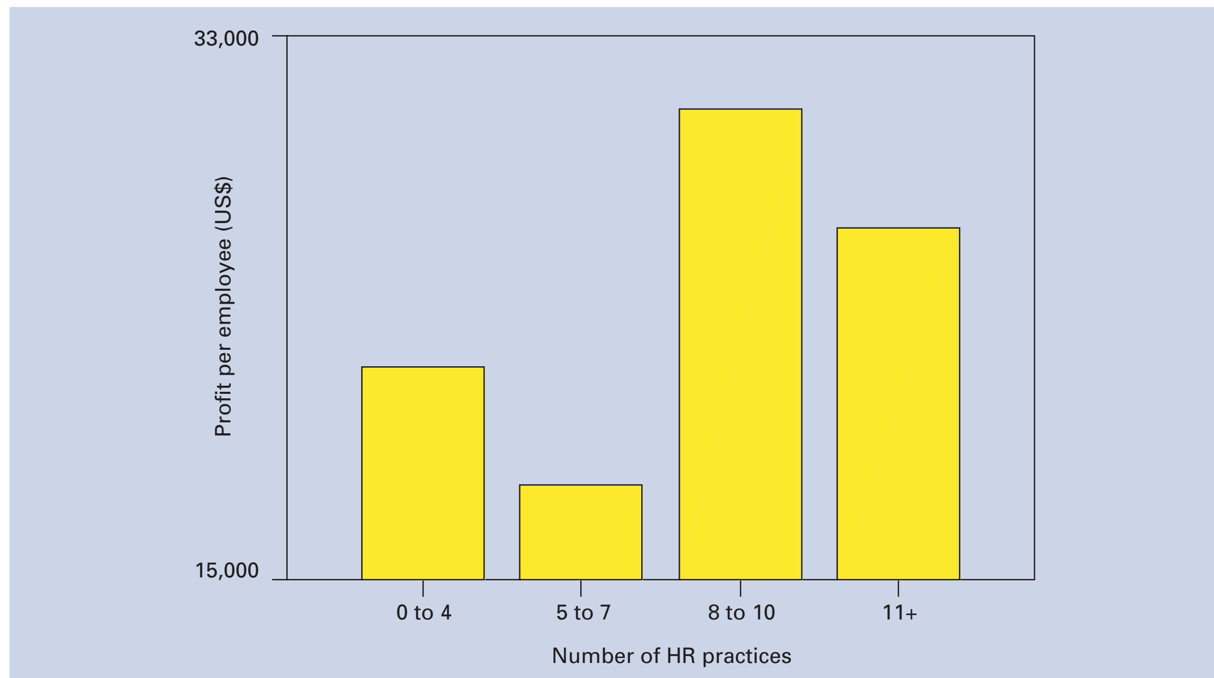
The results for the association between human resource practices and labour turnover tell the same story. Use of a greater number of human resource practices is associated with lower labour turnover. This association remains significant after controlling for a range of background factors. The results are presented in Figure 5.5. This shows the proportion of firms with a labour turnover above 15 per cent. This figure was chosen since it represents the average level of labour turnover in the year the data were collected.

Figure 5.5
HR and employee turnover (UK)



The data from Australia and New Zealand tell a broadly similar story. These studies are more limited since they only included data from human resource directors or managers and because they are cross-sectional. The Australian sample consisted of 714 responses and the New Zealand only had 114. It should also be noted that there is a good study of human resource management and performance in New Zealand that largely complements our own data (Guthrie, 2001). Since we did not have the same access to independent financial data in these countries, we asked for the most recent profit figures. We were able to check these for a cross-section of the responses against the reported profit figures. We found a correlation of 0.90 giving us confidence that the responses provided an accurate picture. This is almost the same as the figure reported by Guthrie when he used a similar approach in his New Zealand study. Given the differences in sample size, we only report the Australian results.

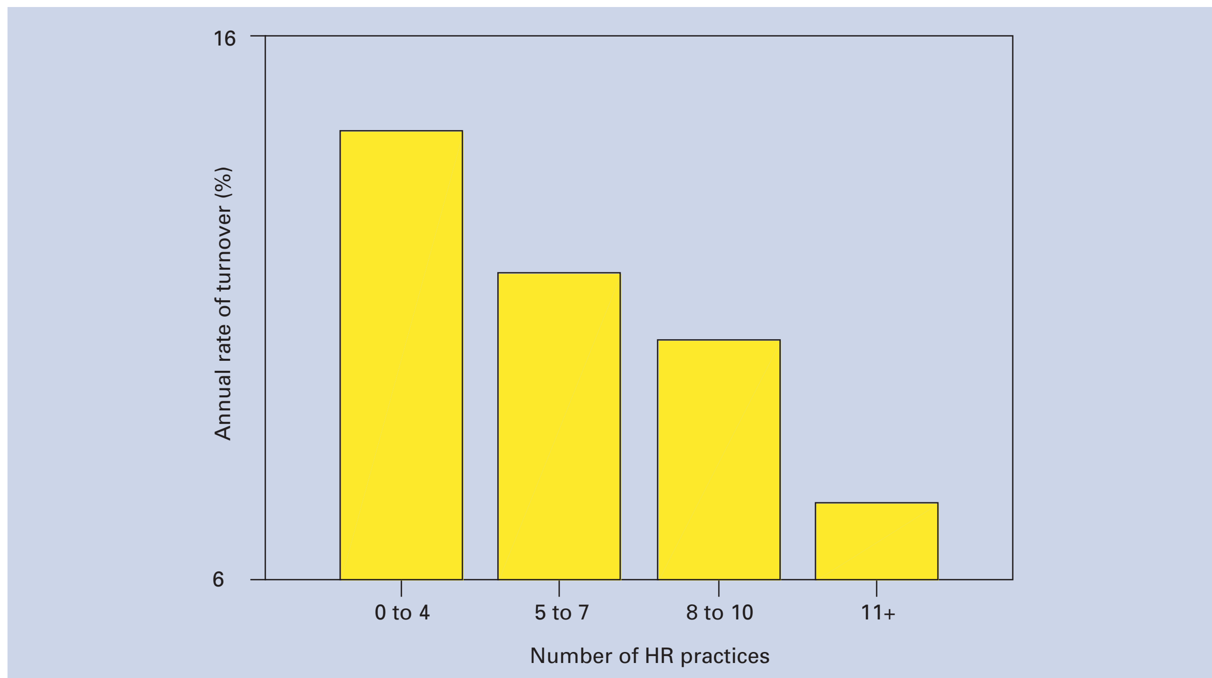
Figure 5.6
HR and profit per employee (Australia)



The Australian results are less clear-cut than those for the UK, although the trend is much the same and there are clearly advantages to having more HR practices in place. In the regression analysis, the association between more HR practices and higher profit per employee remains and the results are significant for the total sample and for both the manufacturing and service sub-sectors. These results, despite their limitations, can be taken as broad support for the association between greater use of human resource practices and firm performance.

Figure 5.7 shows the Australian results for labour turnover. The pattern is very similar to that found in the UK. Given the high costs of labour turnover in many organisations, this is indicative of how greater use of HR practices might affect the bottom line. Since labour turnover is often associated with employee dissatisfaction, this is also a clue to a possible association between greater use of HR practices and higher employee satisfaction. This issue has been explored in more detail elsewhere (Guest, 2002, Guest and Conway, 1999) and confirms that there is a consistent association between the presence of more human resource practices and measures of employee satisfaction and commitment. Another source of evidence in support of this comes from the research on the best companies to work for (see, for example, Gerhart et al, 2004, in the USA and Leary-Joyce, 2004, in the UK)

Figure 5.7
HR and profit per turnover (Australia)



In summary, despite some qualifications about causal links noted above, the evidence from the UK supports that found elsewhere. It is further reinforced by new data from Australia and New Zealand. This, like most studies reported to date, has some methodological flaws, notably in the measures of human resource management and performance. However, it is probably the best source of evidence on this subject with respect to firms in the UK. Huselid in the USA has been conducting an analysis of all the available evidence and finds that about 85 per cent of studies provide evidence in support of a relationship between human resource management and performance. As already noted, many of these studies are of variable quality. However they are sufficient in number to suggest that even if we are unclear about the mechanisms, and allowing for measurement error that may depress the true relationship, there is a strong accumulation of evidence indicating an association between human resource management and performance.

5.4 The Adoption of Human Resource Practices in the UK

Given the accumulating evidence about an association between greater use of human resource practise and financial performance and the arguments about the distinct competitive advantage to be gained by effective adoption of these practices in a way that builds a unique, non-imitable culture of high performance and commitment, we might expect British firms to be adopting human resource practices with some enthusiasm. However this does not appear to be the case.

Figures 8 and 9 show evidence about the use of human resource practices. This is based on two main sources and addresses the adoption of these

practices as both establishment and company level. Figure 5.8 is drawn from the 1998 Workplace Employee Relations Survey (Cully et al, 1999) and covers nearly 2000 workplaces in both the private and public sectors. It reveals a clustering of establishments, more particularly in the public sector, with approximately half the practices in place. In the private sector there is a wider distribution with a small number at both the top and bottom end of the range. A similar picture emerges from the data in Figure 5.9, which are drawn from the company level survey described earlier. One implication of this is that if so few organisations have a large number of human resource practices in place and there is an association between applying more of them and firm performance, then there is a strong financial case to gain competitive advantage by adopting more of them.

Figure 5.8
Adoption of HR Practices in UK Establishments (WERS, 1998)

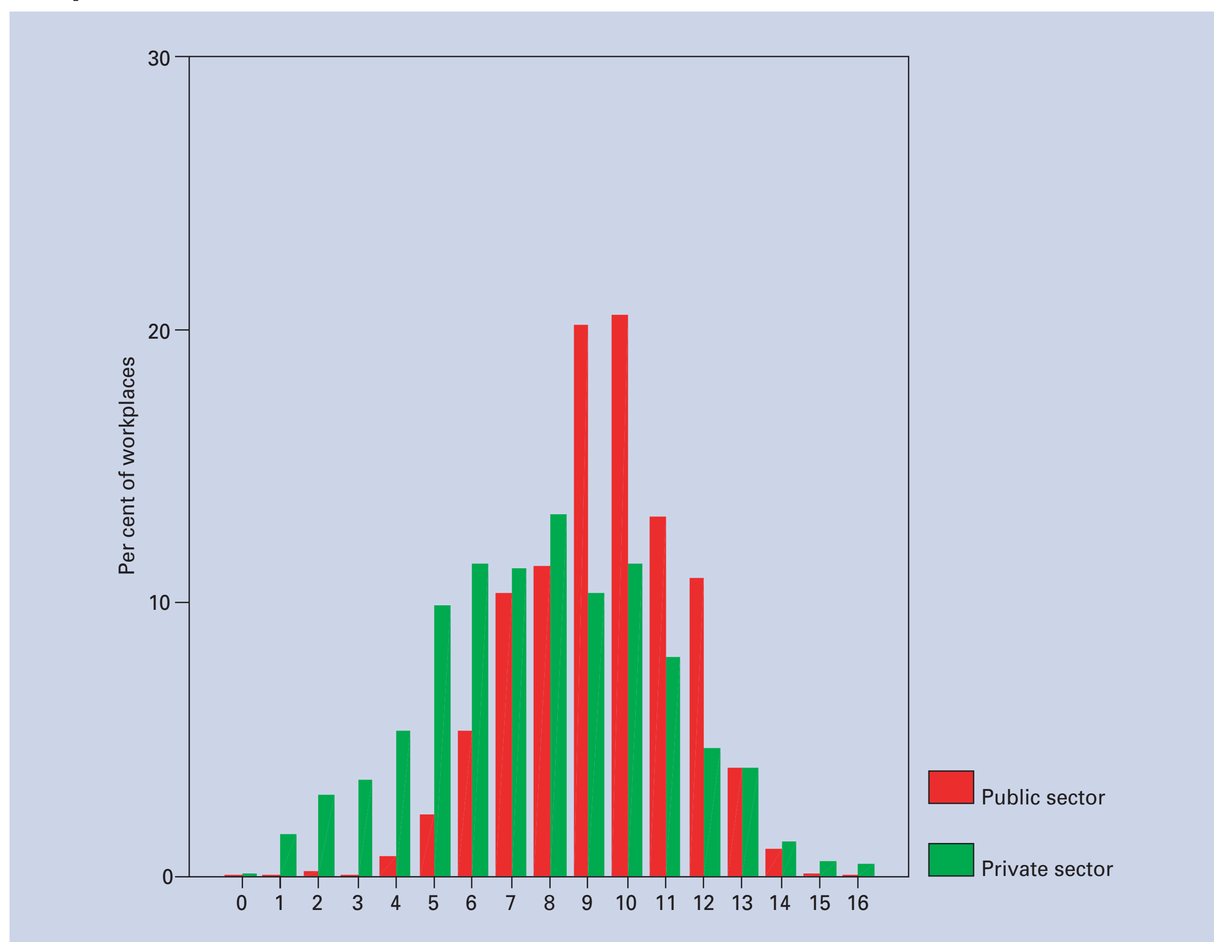
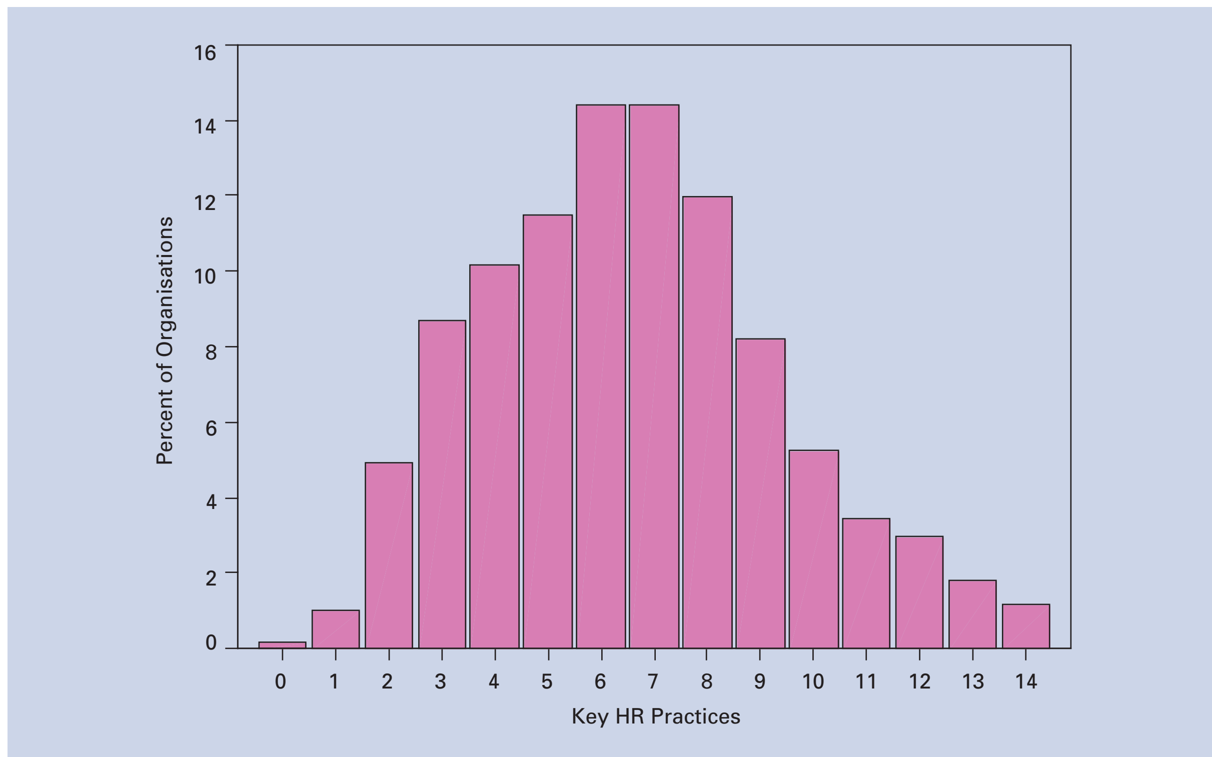


Figure 5.9
Adoption of HR Practices in UK Companies (FoW study)



There is then, a puzzle in these figures about the adoption of human resource practices. If there is a powerful financial case for their adoption, then why are more firms not doing so? To explore this issue, with further support from the CIPD we conducted interviews with chief executives, operations directors and human resource directors from 16 sizeable organisations drawn from both the private and public sectors (Guest and King, 2001, 2004). A number of possible explanations for the low adoption of human resource practices were considered. They included the possibilities that directors:

- Are not aware of the evidence
- Are aware of the research but do not believe it
- Do not believe the research is relevant to them
- Believe they already implement a full set of HR practices
- Are sceptical about all ideas associated with human resources due either to a suspicion of fads and fashions or a lack of respect for the function
- Have more important priorities
- Lack the resources or capacity to introduce more practices
- Do not know how to implement more practices, what to prioritise or where to start

The interviews revealed limited specific awareness of the research findings but some understanding of the broad message. Furthermore, despite a deep

dislike of the cliché, most accepted that their people were their most important assets. Those who were aware of the research, and others who were introduced to it were willing to accept the existence of an association between HRM and performance but were reluctant to accept the implied strength of the causal link. Several also believed that they already did a good job in managing human resources; indeed, there was little evidence of any strong desire to introduce more HR practices. It emerged that research and other kinds of evidence were often downplayed if they did not come from what was perceived to be a relevant context. Therefore those working in banking placed little weight on findings coming from manufacturing or many parts of the service sector. They were most interested in innovations either in other organisations in their specific sector or, more particularly, in other parts of their own organisation if it was an organisation of some size.

A key problem that emerged was a perceived association between human resource practices and cumbersome organisational bureaucracy. This was summed up by one operational director as follows:

> "In our organisation we have an HR function which is steeped in a process mindset to do with grading, competency frameworks, appraisal systems, which have the design of a push me-pull you type of animal that doesn't achieve anything. Glorious in their construct but bloody useless in their implementation". (Operational Director)

There is also plenty of evidence of more pressing priorities, illustrated in the following quotes:

> "I don't really think it is money. It is that there are only so many hours in a day. How do you balance the needs of trying to run a business in terms of turning out products…and whatever, whilst investing the effort in trying to help people to grow and develop". (CEO)

> "I think it is the pressure, the fact that there are deadlines to meet, products to deliver, within cost constraints and revenue requirements and all that kind of stuff, and so from time to time HR policies and practices get in the way, if you want, of how people like to organise themselves". (Director)

The lack of resources as an explanation for the limited application of human resource practices was only cited in the public sector. As one NHS Trust chief executive put it:

> "The obvious headline constraint is money. Like every Trust, every hospital, the amount of money we have is insufficient to do all the things we want to do. But if they double the money they give me, there would still be aspirations, people aspirations, that weren't being met". (CEO)

The final constraint on the adoption of more human resource practices is the challenge of change. There is deep scepticism about the ability of the human

resource department to introduce the kind of changes that will make a difference. Two comments illustrate these concerns in rather different ways:

> "I would say that in general whenever HR took the lead in trying to implement the results (of an attitude survey) it was a disaster. And whenever senior management took the lead, there was great improvement. And yet there was the risk that because HR had done the surveys….well then why don't you go out and go forth and do the improvements from the surveys and it was delegated back to the HR function" (CEO).
>
> "If there is one part of the organisation that doesn't look as if it takes HR principles seriously, it is HR – now I don't know whether it is true in other organisations but if you looked at some of the sloppy ways HR recruits for HR, if you looked at the amount of training HR individuals go on themselves, if you look at how well the performance measurement system works for HR executives, the answer is poor, poor and poor". (Operational Director).

Alongside these concerns about the ability of the HR department to implement effective change, there is the question of how to implement an "HR system". The question of where to start cannot be answered without an awareness of where the organisation is starting from. However attempts to indicate which individual practices, either singly or in combination are most likely to be associated with superior outcomes (see, for example, Guest, Conway and Dewe, 2004) suggest that job design, which promotes the opportunity to contribute but also has a motivational dimension, may be a priority. Training and development also seems to justify some priority. The problem with job design is that it does not clearly fall within the remit of either the HR department or indeed any other department and in the surveys of practices is one of those less likely to be reported. Therefore the ideal place to start may be one of the most difficult places to start.

5.5 Summary and Conclusions

The Kingsmill Report recognised the need to place the management of the workforce firmly in the arena of corporate governance. The evidence presented here indicates that the adoption of a set of progressive human resource practices is associated with superior business performance. Furthermore, these practices are also associated with lower labour turnover and higher employee satisfaction and well-being. Despite this evidence, many UK firms have been slow to adopt these practices and there is some indication that those in senior positions who share the responsibility for corporate governance tend to be rather complacent about their human resource practices, giving a relatively low priority to further investment in them.

It is possible to discern in the research evidence the outline of a potentially benevolent cycle of governance whereby the 'good' employer, defined in terms of paying close attention to the effective management of the workforce, and

reflected in adoption of progressive human resource practices, is associated with superior business performance which may in turn create more scope to invest in the management of the workforce. This is a goal for corporate governance to which organisations might aspire and towards which many organisations still have some distance to travel.

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