# Treasure Chest And Pandora’s Box In One: A discussion of “The Evolution of Ownership and Control Around the World: The Changing Face of Capitalism” by Julian Franks and Colin Mayer

Kevin R. James
Systemic Risk Centre
London School of Economics

k.james1@lse.ac.uk

# Overview

- This paper is a treasure chest of insight and facts about the evolution of ownership and control in corporations that will give anyone interested in this topic much to ponder upon;
- The paper makes a strong case for “masterly inactivity” on the regulatory front; and
- The paper really calls into question the validity of standard empirical techniques used to investigate the effectiveness of corporate governance practices

# The Treasure Chest

- The paper departs from the observation that firms need to get outside suppliers of capital to trust them with their money and stakeholders (employees, suppliers, customers) to trust them to uphold their end of the bargains they enter into;

- Obviously, all parties will benefit enormously if they can find a solution to this double-sided trust problem…

- The paper documents the many marvelous and intricate market solutions that have emerged in (mainly) the UK, Japan, Germany and the US:

    - A Market Solution: A set of contracts, institutions, and/or modes of behavior that reduce the adverse consequences that transaction costs would otherwise create;

# The Big Picture

- The optimal corporate governance solution varies a lot with the environment, and the environment changes over time within and between countries;
    - Consequently, the observed structure of ownership and control has shifted dramatically over time within and across countries in ways that one would not have expected just looking at a snapshot in 1990;
- Regulation is part of the environment within corporate governance solutions evolve, but maybe not the most important part;
        - It is remarkable how firms in the early part of the 20th century could create the levels of trust required to support diffuse share-holdings with so little formal investor protection regulation;

# Masterly Inactivity

- The paper shows that:
    - There is no unique time and environment-invariant optimal solution to the ownership and governance question;
    - And, while there may be an optimal solution for right now, it is both hard for regulators to know what it is and hard to design a framework that will both work now and be flexible enough to work for the different solution that will be optimal in the (probably) not too distant future;
    - Consequently, the best course of action is: let a hundred flowers bloom by adopting enabling rather than prescriptive regulation;

People do always optimize given their environment…

…but maybe some environments are better to optimize in than others!

# The case of India

- India has about 300 million or so people in extreme poverty;
- If India can achieve a growth rate of 6%, per capital income will quadruple in the next 24 years, bringing India's per capita income up to the level of Chile today. This would help to reduce but would not eliminate extreme poverty;
- But, if India can gets its growth rate up to 9% per year, per capita income will increase by 8 times to roughly the level of a high-income country today. That would substantially eliminate extreme poverty;
- Could improving corporate governance in India improve the growth rate? It is important to find out!

# Pandora’s Box

- Now, the usual way to investigate what works in corporate governance is to:
  - Form a panel of countries to get enough data to enable one to control for alternative hypotheses;
  - Code in some corporate governance provisions in a 0/1 manner;
  - Control for country effects with a country fixed effects; and
  - Control for endogeneity with a Legal Origin;
  - And then run the regressions.
- That strategy just will not work;
  - Country effects are not fixed, Legal Origin does not sort countries in a meaningful way

# Conclusion

- This paper does a fantastic job of illustrating how market participants can evolve intricate and effective market solutions to market imperfections that would otherwise prevent beneficial exchange given the economic, social, and regulatory environment within which they operate;

- The wild experimentation on both the market and regulatory side that we have seen over the last 120 years will (one might hope) provide some insight for both market participants and regulators into how to create a framework that steers the evolution of corporate governance along a beneficial path;

- Unfortunately, this paper also makes clear the fact that studying the effectiveness of corporate governance regimes will be more complicated than we had previously supposed.