THE CORPORATION UNDER ATTACK I:
Corporate Governance

By

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With the various corporate scandals involving some of the biggest US corporations like Enron and World Com, the question of corporate governance has come to the fore. These scandals following the dot com speculative bubble have furthered moral outrage at the behavior of corporations, with demands that governments should find ways of improving corporate governance. Many are advocating ‘stakeholder’ capitalism over the ‘shareholder’ capitalism enshrined in the Anglo-American classical liberal tradition, and many corporations have succumbed to the demands for ‘corporate social responsibility’.

For various historical reasons, the shareholder capitalism embodied in the Anglo-American corporation was not emulated by Japan or the continental European countries. They had a form of corporatism which has been called “stake holder” capitalism in which there is collusion between industry, banks, governments and trade unions—the so called stake holders. The outcome has been greater inefficiency as well as covert corruption than in the Anglo-American share-holder version, and was one of the causes of the Asian financial crisis. But the Anglo-American version of corporate capitalism, with its separation of the ownership of the corporation from its management, leads to the danger that managers instead of maximizing the value of the corporation to its shareholders, will use their position to feather their own nests.

The major way to prevent managers from milking share holders was through the hostile takeover—hostile to the company’s management but friendly to its share-holders. If a management was not maximizing share holder value, and using the company’s profits for its own ends, its share price would decline compared to other companies in the industry. A corporate raider could offer the shareholders a deal whereby he offered to buy their shares at a premium, take over the corporation and serve share-holder rather than managerial interests. The existing management would of course be sacked. It is this market for corporate control which would control bad managers. Gordon Gekko is good for the market.

In the late 1950's to mid 1960's there was a fairly unregulated market for corporate control in the US. In the ensuing takeovers, shareholders received on average 40% over the pre-bid price for their shares. But, following the howls of protests by threatened managers, the US Congress passed the Williams Act in 1968. This removed the highly profitable element of surprise in hostile takeovers and made it more expensive for outsiders to mount a successful bid. But, it did not kill hostile take-overs. There was a wave of hostile takeovers in the 1980's which restructured US business. Over half of US corporations became targets, while many others restructured to avoid becoming targets. This led the management’s of the largest US corporations to petition state governments for protection from corporate ‘raiders’. The legislatures and courts obliged. The number of hostile bids declined precipitously. The takeovers which took place were through friendly mergers. In these the incumbent managers agree to cede control in return for lucrative consulting arrangements, stock or stock options in the acquiring company, generous
severance packages and other bonuses. The managers in these mergers got the largest share of the premium being paid for control of the company, rather than the share-holders. As hostile takeovers declined from 14% of all mergers in the 1980's to 4% in the 1990's not surprisingly executive compensation soared. Every statute, adjudication, or regulation that in any way inhibited the free functioning of the market for corporate control simply raised the real cost of ousting inappropriate managers. These costs led to incumbent managers granting themselves greater rewards or maintaining inefficient management policies. Until the real cost of wastefulness equals the cost of a successful takeover fight, they would remain secure behind a legal barrier to their ouster, until of course the firm became so inefficient that it collapsed.

This is, of course, the predictable outcome of regulations which seek to tamper with the free functioning of the market- in this case the market for corporate control. This attenuation of the market by making hostile takeovers more difficult was worsened by another feature of the post war fiscal system- the double taxation of dividends. In both America and Britain, the profits of corporations which belong to shareholders were first taxed through corporation tax. Then, when part of these post tax profits were paid as dividends to share holders they were again taxed as part of their income. This greatly reduced the post tax return to investors from shares in corporations. Most of their returns depended upon rises in the share price which in large part depended upon the ploughing back of the profits of the company into new and hopefully profitable investments. As one of the remedies to motivate managers to take account of share holder value was to link their remuneration to stock options, both mangers and share holders had a common interest in seeing the price of the company’s shares rise. This gave an incentive to managers to manipulate their share price through the fraudulent practices shown up by the Enron and other scandals during the 1990's stock market bubble. But, though there is a lot of wringing of hands at these clearly illegal accounting practices, as my UCLA colleague Harold Demsetz has drily remarked:"Indeed I wonder just how many share holders might have objected to these misrepresentations if they had believed they would remain undiscovered". The proposed removal of the tax on dividends in the US will help corporate governance, for with the tax on corporate profits still in place, it will provide incentives for managers to retain less of post tax profits and pay more out in dividends, which will shift resources from the control of management to share holders.

The perceived ills of Anglo-American share-holder capitalism shown up in the bursting of the 1990's stock market bubble are not, therefore, a sign of some decrease in corporate morality- though there have been some clearly illegal practices which are rightly being dealt with by the law- but because of the perverse incentives created for managerial ‘rent seeking’ by the regulations limiting hostile takeovers, and the unintended effects of fiscal policy through the double taxation of dividends. With the double taxation of dividends due to end, if all the regulations preventing hostile takeovers can also be repealed, so that the unregulated market for corporate governance can once again do its work in providing checks on predatory managements, executive compensation will begin to fall, accountants will have less pressure to cook the books, and the Anglo-American corporation would pursue the innovation, efficiency and profitability that has, till now, been its hallmark.

But there is one other cloud on the horizon. Various activists have been successful in persuading many people and corporations in the previous citadels of Anglo-American capitalism that corporations have a ‘social responsibility’ to pursue ‘sustainable development’. I will
discuss this issue in my next column.