

Shareholder vs. Stakeholder: Two Approaches to Corporate Governance

Most managers in the United States would shed workers to sustain profitability, whereas Japanese firms often consider job security one of their primary concerns. Both approaches, and their economic impact, can be explained through insider and outsider models of corporate governance.



August 7, 2008

In countries with an Anglo-Saxon legal tradition, such as the United States, United Kingdom, Canada and Australia, corporate governance typically focuses on the firm's outside investors,

mainly shareholders. In those countries, top managers tend to be monitored by means of market-based rewards and penalties. For instance, in the United States, where compensation is often tied to the level of profitability, most firms would opt to cut back on labor in order to sustain current profitability.

Under this system, employees often find it difficult to trust top management, as their behavior is subject to constant market scrutiny. In countries such as Germany or Japan, where stakeholder claims are typically taken into account in top management decisions, job security becomes a main corporate objective. Canon, for example, has never laid off employees in its entire history, despite all the ups and downs in profitability.

In Germany, employees are influential stakeholders whose welfare is internalized to a certain extent by top managers through co-determination systems of governance, having small percentages of the firm's total stock in free-float, and making the managers' compensation not so focused on current profitability.

It is assumed that corporate governance is determined by a set of mutually reinforcing institutional elements: disclosure, the board of directors, hostile takeovers, legal systems, transparency, accountability, separation of CEO and chair, stock in capital markets, personnel turnover, unionization, flexibility of labor markets and so on. And it is the existence of complementarities between configurations that determines the economic success of different corporate governance arrangements at an individual country level.

In "[A Cross-National Study of Corporate Governance and Employment Contracts](#)," authors [Roberto García-Castro](#), [Miguel A. Ariño](#), Miguel A. Rodriguez and Silvia Ayuso look again at the way firms around the world configure their corporate governance and find that everything can be summed up in two competing models: the shareholder-centered or outsider view versus the stakeholder-centered or insider approach.

Governance Structures

In the outsider model of corporate governance, the nature of interactions is transactional, where interactions are assumed to be frozen in space and time and isolated from any institutional context. This model relies on the strength of the markets — both capital and labor — to allocate resources correctly within firms. It also relies on high-powered incentives and external control systems to discipline and align managers' interests.

Proponents of the outsider model accept the opportunistic tendencies of management and

recognize the divergent goals of shareholders and management. Therefore, they argue for external control systems that can effectively monitor and impose constraints on managerial discretion. Measures used to make managers more accountable include executive compensation schemes, such as performance-based bonuses, stock options or performance-based dismissal decisions.

Governance structures — such as the board of directors, union representation on the board of directors and the legal superstructure — are used as mechanisms to ensure fulfillment of implicit and explicit contracts, all aimed at better serving the interests of shareholders. In general, a firm with an outsider model of corporate governance will have a higher proportion of performance-based executive compensation and will adopt more externally verifiable control mechanisms in the board of directors' roles and structure.

In an insider model of corporate governance, the interactions are defined by formal and informal rules developed over the relationship's history. In the insider model, the debt-equity ratio will be higher. They will have lower levels of turnover and layoffs, stronger worker displacement policies, higher levels of firm-specific training for employees, higher employee-firm fit, higher internal knowledge sharing and joint organizational learning among employees in comparison with the outsider model.

See also "[Maximizing Stakeholders' Interests: Empirical Insights](#)"

International Landscape

The classification of countries according to their corporate governance model can be divided into four categories: the Anglo-Saxon, French, German and Scandinavian traditions. Together these four categories account for virtually every capitalist country in the world. In general, countries with an Anglo-Saxon legal tradition have favored a shareholder-centered model of corporate governance. In these countries, firms typically adapt their strategies to the demands of capital markets and, hence, we expect to see lower levels of firm commitment and involvement with their workforce and vice versa.

Countries with a German legal tradition are broadly defined as stakeholder-oriented industrial systems. Most German and Austrian firms, for example, have adopted the policies typical of the insider model of governance based on standards of employment security, high employee involvement practices and a tendency to adopt relatively less corporate governance external control policies than firms in Anglo-Saxon related countries. These firms also show a pattern of marginal adoption of external alignment systems, such as stock options, and a financial

structure characterized by a high weight of debt in relation to equity.

The countries following the Scandinavian and French traditions are more difficult to classify purely as stakeholder or shareholder economies. Yet, they generally fall into the non-shareholder oriented economies that embrace most of the elements of the stakeholder model. In this study, Anglo-Saxon tradition countries were defined as outsiders (shareholder-oriented) and the remaining countries were defined as insiders (stakeholder-oriented).

See also ["The Need for Investors to Wield More Board Influence"](#)

Shareholder vs. Stakeholder

Through a careful study of shareholder-management (corporate governance) and management-employee (labor management) relationships, the authors assert that employees should have a preeminent position among stakeholders, whenever their firm-specific investments are critical for the wealth-creation process characteristic of economic organizations. Being the employees, they are potential beneficiaries of those firm-specific investments, but also their risk bearers.

Ultimately the question is, if the same problems affect all corporations, why then is it that they are addressed in substantially different ways in different firms and countries? Firms in different countries embrace different types of relationships with their shareholders and employees. By analyzing the variables over which firms and their managers have some discretion, instead of relying exclusively on country-level attributes, the authors conclude that firms differ by adopting one of two polarized systems — that is, either shareholder or stakeholder and that the higher the complementarity between the different attributes of each system, the higher the observed economic performance for that firm.

See also ["Managing Stakeholders Well Pays Off — in the Long Run"](#)

www.iese.edu/insight