Trade-offs in corporate governance

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EXECUTIVE SUMMARY

Within the vast literature on corporate governance, this article analyzes the main findings, challenges and shortcomings of a series of prevailing organizational "conflicts" or trade-offs among mechanisms of governance within corporations.

Section 1 offers a brief overview of the literature that underlines the pervasiveness of conflict within corporations. There are unavoidable trade-offs between desirable characteristics; moving from one organizational form to another will solve some problems of "adverse selection" or "moral hazard", but at the price of crating others.

Section 2 covers the trade-offs that more directly affect the vertical relationship between employers and employees, or, more generally, those between the superiors and the subordinates in an organization. It starts analyzing the "foundational" trade-offs of a corporation: why, in the first place, should an entrepreneur build a corporation instead of relying on the voluntary mechanism of the market? And, once we have a corporation, should we choose a more hierarchical form of governing employees or a more market-like one?

Section 3 deals with more horizontal trade-offs within corporations. First and foremost, those generated by the unavoidable conflict between shareholders and managers that emerge in those corporations where ownership is separated from control. This conflict is probably the most vastly explored in the literature, yet there are many others and this article will pay some attention to another relevant conflict: that between controlling and minority shareholders.

In the light of the literature explored here, Section 4 offers a tentative list of venues for future research in corporate governance.

> A high wage will not elicit effective work from those who feel themselves outcasts and slaves, nor a low wage preclude it from those who feel themselves part of a community of free men (Robertson 1921: 244).

Firms as Political Economies

Comparing Governance Structures. A look at the literature on comparative corporate governance resembles a review of the scholarship in comparative politics. The different components or variables in which we can disaggregate corporate governance structure (e.g. the degree of concentration of ownership in firm, shareholders' voting rights, the size of the board, the separation between chairman of the board and CEO) or a political system (e.g. degree of electoral competition, type of electoral system, presidential vs. parliamentary system) appear as exerting a significant effect on standard indicators of firms and government performance respectively in a large number of studies from both OECD and developing countries. Yet, at the same time, the statistically significant effects of those governance characteristics do not seem to be unidirectional, and we tend to encounter U-shaped relationships, interactions and contingency effects.

For instance, some variables (e.g. the size of the board), seem to exert a positive effect over firm performance up to a (frequently controversial) turning point and a negative effect from that threshold onwards (Lipton and Lorsch 1992, Jensen 1993). Other governance features (e.g. separating the roles of chairman and CEOs) seem to positively affect performance of large firms while negatively affect small ones (Palmon and Wald 2002). Studies of the effects of the same variables in similar firms within a similar period of time, but in different countries may shed opposite results, such as the better performance of merging the jobs of chairman and CEO in the case US firms (Boyd 1995) and the worse performance in the case of UK firms (Dahya, Lonie and Power 1996). One can thus hardly identify "best practices" or "best corporate features" that travel well across countries, economic sectors and types of firms. Likewise, in comparative politics, there are many controversies in the scholarship regarding which features of a political system lead to "better performance"; for example, in terms of less rent-seeking and more non-targeted public goods (Keefer 2007).

Similar to what happens in political systems (e.g. Miller and Hammond 1994), the "ideal" institutional setting for a firm seem to be not only empirically unidentifiable but also theoretically impossible. The reason for this parallelism is that the problems for which the state and the firm are founded in the first place – the problem of how to provide public goods in the case of the state and the problem of how to deal with team production in the case of the firm – are "structurally identical" (Falaschetti and Miller 2001, 391): in both cases individuals (e.g. employees or managers in the firm, tax-payers and rulers in the state) have a dominant strategy to free ride because their actions are costly to observe. Both the firm and the nation-state are "political economies", that is, mechanisms that allocate resources without explicitly pricing them, and, as a result, there is always the possibility of opportunistic behavior by some actor.[1]

The Fundamental Political Problem. Corporations are trapped in different manifestations of the so-called Holmstrom's (1982) *impossibility theorem*: it is impossible to design an incentive system within firms that fulfills some basic desirable aims to prevent hidden action or hidden information by some actors within the corporation. In technical terms, there is not a perfect contractual arrangement for a firm that, at the same time, is a Nash equilibrium (i.e. the best course of action for everyone in a firm), Pareto efficient (i.e. there is no better outcome) and budget-balancing (i.e. the firm is profitable). Put simply, we cannot perfectly align the interests of all actors within a corporation without allocating a certain margin of maneuver for opportunism in one or several actors – employees, managers, directors or shareholders.

In practice, the most prevailing common problem in both firms and states is that the only way of getting a "truthful message" from the members of the group (i.e. a message on how much effort they can undertake to achieve the desired product for firms; and a message on how much effort they can undertake for the provision of a desired public good for states) is to rely on a central official (i.e. owner in the firm, ruler in the state) who will "inevitably be left with a 'residual' profit" (Miller and Hammond 1994, 10). Consequently, both firms and states face a basic common problem: who shall guard this guardian?

Similar to the scholarship in political science, a powerful conclusion emerges from a view of the literature of corporate governance as a whole (Miller 2005, 349): that there is no unique "solution" to the problems created by the different chains of principal-agent relationships among the main agents within a firm: shareholders, boards of directors, managers and employees. There are many organizational trade-offs within firms (e.g. giving incentives vs. giving confidence) and choosing one particular corporate feature over another (e.g. stock options vs. flat salaries) implies translating the opportunities for rent-seeking from one agent to another (Miller 1992). The fact that no corporate governance solution is perfect does not mean that there are not specific governance features systematically better than others under certain circumstances. Our challenge as researchers as well as "one of the tricks of good management is therefore to be sensitive to trade-offs between different kinds of costs associated with different transactional arrangements" (Miller 2005, 350) among all agents within the firm.

This article offers an overview of key trade-offs, conflicts and dilemmas explored by the corporate governance literature. Despite the large amount of heterogeneous literature reviewed, a common theme resonates. Firms, like states, are political economies subject to constant political tensions among actors with divergent interests. At first sight, one would expect those internal-to-the-firm tensions to be increasingly alleviated in a globalized world with ever-expanding information

[1] A pioneer scholar in importing insights from politics to the study of private organizations is Alfred D. Chandler (1966, 1990). For instance, in *Scale and Scope: the Dynamics of Industrial Capitalism* (1990), he compared the federation of some tobacco companies with that of the Thirteen States of America, because in both cases there was a tension between an increasingly powerful central government and older local authorities.

technologies in which shareholders, managers and employees have better "exit" options. For example, the particular shareholders of a given firm should find easier to find the particular CEO that best suits their interests now than years or decades ago.

An Increasing "Politicization" of the Corporation? Yet, these tensions seem to be, if any, increasing in relevance. I would like to highlight two related issues that point out towards what could be called a "politicization" of corporate relationships. In the first place, after an initial consensus in blaming the 2007-2008 financial crisis to informational problems (i.e. CEOs were unaware of the level of "toxicity" of certain financial products), there is an increasing number of scholars who underline the lack of appropriate organizational watchdogs (or "guardians") over short-term-driven CEOs in those financial institutions more severely affected by the crisis.

Secondly, a relatively recent scholarship notes the increasing political visibility of the "cleavage" between shareholders and managers. The underlying reason would be that shareholders' and manager's interests have been progressively coming more apart – especially since the late 1970s, given the increase in the scope and relevance of hostile takeovers. The rise of the junk bond market in the 1980s triggered an expansion of hostile-takeover offers. Hostile takeovers can be interpreted as "breaches of trust" (using the famous definition popularized by Shleifer and Summers 1988), because they may transfer wealth to shareholders at the expense of corporate managers --who, for instance, may lose their jobs. In response to the expansion of hostile-takeovers, corporate managers started to demand regulations aimed at restricting shareholders rights, such as different sorts of takeover defenses or limits to shareholders' ability to meet or act (Gompers *et al.* 2003: 1). Accordingly, for the last three decades managers and shareholders have been fighting a growing number of legal and legislative battles (Adams and Matheson 2001). These fights are increasingly visible in the realm of party politics. In the US, while Republicans tend to align with managers' interests (e.g. the Republicans passed the "pro-managers" 1995 Private Securities Litigation Reform Act, over a veto by President Clinton, and the 1998 Securities Litigation Uniform Standards Act), Democrats tend to represent shareholders' (e.g. they fostered the "pro-shareholders" 2000 Regulation Fair Disclosure).

This American form of shareholders-managers conflict, what is known in the literature as Type I conflict (Ben Ali 2009), is difficult to find in other economies with the same sort of emphasis (Fligstein 2001). US corporations have traditionally been examples of a combination of relatively fragmented ownership and relatively powerful CEOs. In Europe, on the contrary, the so-called Type II conflict – that between controlling and minority shareholders – is probably more relevant than that the Type I conflict (Ben Ali 2009). Yet scholars in comparative regulatory policy have already started to notice the emergence of political coalitions similar to those in the US. During the latest decades there has been a notable rise in shareholding across all socio-economic strata in the electorates of OECD countries. In particular, more employees have become shareholders, among other reasons as an alternative or complementary form of saving for pension. As a matter of fact, investors managing pension funds have become strong vocal advocates of corporate governance reform all over the world, promoting innovative measures to protect shareholders' rights. For example, the Norges Bank Investment Management (NBIM), which manages a state pension fund of $400 billion, has tried to persuade the corporations in which it is investing to split the jobs of CEO and chairman of the board (*The Economist*, 17-10-2009).

As a result, in many OECD countries workers and shareholders are gradually forming what Gourevitch and Shinn (2005) called "transparency coalitions". These coalitions tend to be represented by center-left parties who, having overcome their traditional opposition to shareholders' requests, are driving forces of most of the recent pro-shareholders regulatory reforms (Cioffi and Höpner 2006). Outcomes of this relatively new alliance between shareholders' interests and center-left parties would include the French 2001

"New Economic Regulations" Act, the 1998 "Dragui reforms" in Italy, or the German Corporate Governance Commission in 2000. On the contrary, long-lasting established alliances with corporate managers have constrained right-wing parties for clearly endorsing pro-shareholders regulations in countries like Germany, France and Italy.

The remaining of this article explores in a bit more of detail some particularly relevant trade-offs corporations face, with special attention to those that generate more controversy in the literature. Section 2 covers those trade-offs that more directly affect the vertical relationship between employers and employees, or, more generally, those between the superiors and the subordinates in an organization. The section will cover the "foundational" trade-offs of a corporation: why, in the first place, should an entrepreneur build a corporation instead of relying in the voluntary mechanism of the market? And, once we have a corporation, should we choose a more hierarchical form of governing employees or a more market-like one? Section 3 deals with more horizontal trade-offs within corporations. First and foremost, those generated by the unavoidable conflict between shareholders and managers that emerge in those corporations where ownership is separated from control. This conflict is probably the most vastly explored in the literature, yet there are many others and this article will pay some attention to another relevant conflict: that between controlling and minority shareholders. Section 4 concludes with pointing out some venues for future research.

Vertical Trade-offs. Relationships between Employers and Employees

Market or Hierarchy? The first dilemma any entrepreneur faces is that of "buy or make". In order to get what I want, should I resort to the voluntary exchange of the market in which I pay a fixed price for a defined product/service, or should I instead create a hierarchical organization (i.e. the firm) in which a central authority will coordinate the production of what I want?

As Coase noted in 1937, one would not expect, following neoclassical economics, firms to exist since every single economic transaction between humans should be priced. Yet obviously many firms or "hierarchies" do exist in reality. The reason for their existence would be, according to Coase and to the New Institutionalist Economics (NIE) school of thought that has followed his work, that transactions are costly. There are transaction costs that make difficult many market operations. Every time we need a particular component or a particular service, we face, first, costs of information gathering and evaluation on the best available providers, costs of negotiating separate agreements and costs of contract enforcement.

A hierarchical organization (the firm or the corporation) may be a more efficient mechanism than a market when transaction costs are relatively high, "for this series of contracts is substituted one… whereby the factor, for a certain remuneration (which may be fixed or fluctuating) agrees to obey the directions of an entrepreneur within certain limits" (Coase 1937, 391). Among the NIE scholarship that has continued Coase's exploration of the dilemma "when should an entrepreneur create a firm or 'make' and when should she 'buy' a given product or service?", the work of the 2009 Nobel laureate economist Oliver Williamson is probably the most encompassing one. His 1975 book *Markets and Hierarchies* represents a cornerstone in the field, but posterior works may be more synthetic and easy to follow (Williamson 1981, 1985, 1990, 1994, 1999). The reviews of the literature by Joskow (2004) and Klein (2004) offer a good overview of the progresses and challenges of this literature when it comes to explain in which circumstances should firms exist or not.

A Market-Like or a Hierarchy-Like Firm? The same logic of Coase's argument can be applied to the transactions that take place within the firm (Miller 2005). Once we have a firm, we can organize it to resemble more an internal market mechanism, in which employer and employee transact on the basis of an incentive system – that is, the employee gets a bonus or variable commissions in function of her performance – instead of, or as a complement to, a relatively low flat salary. This is likely to happen in those firms (or job positions) that require the employee to establish a close relationship with the customer (Eisenhart 1988). On the contrary, routine jobs tend to be more organized in a hierarchical way, in which incentives are replaced by direct monitoring. Incentives and monitoring are thus alternative mechanisms of governance and the firms that opt for monitoring solutions tend to look very different than those based on incentives (Miller 2005). The more market-like internal solutions a firm has, both the more worker freedom and the more worker ownership of assets will be (Holmstrom and Milgrom 1994). On the contrary, firms that rely on monitoring tend to be more hierarchical, more rule-bound and, in general, they are more intrusive of the employee's autonomy (Miller 2005).

Which organizational type of firm is better, the one leaning towards an internal market or the more hierarchical one? The studies exploring the effects of significant organizational changes in firms do not provide convincing evidence for any of the two options. On the one hand, some studies have recorded outstanding increases in productivity in firms that move from "hierarchy-like" flat salaries to "market-like" piece rate systems, of up to a third (Lazear 1996). On the other hand, in other firms, such as in the classic example of the Du Pont fibers division (Hays 1998, Miller 1992), the introduction of incentives did not alter the prevailing group work norms, because employees suspected the management would, ex post, manipulate the incentive system to its advantage – and at the expense of the workers.

Nevertheless, if incentives are problematic, monitoring is obviously costly for an organization. In addition, the intrusion of an employee's autonomy – inherent to all monitoring system, yet relatively overlooked in the literature – can also be a source of organizational inefficiency. Monitoring may lead to what some refer to as the "control paradox" (Miller 2004:99) and others as the "paradox of trust" (Murnighan, Malhotra and Weber 2004:293). High degrees of surveillance – aimed theoretically at forcing employees to be trustworthy – may end up provoking resistance rather than cooperation among employees. Levi (2005) recalls how psychologists have demonstrated that strong levels of supervision may produce paranoid social cognition even among normal individuals.

Monitoring, Incentives or Gifts? In sum, both organizational ideal-types of firms – the more hierarchical and the more market-like – seem to "fall short of a first-best solution" (Miller 2005, 360). There is a margin of improvement of organizational efficiency and the business literature has noted how many firms try to achieve it resorting to a classic mechanism in sociology: the gift exchange. Following Mauss' (1950, 65) famous statement – "*a considerable part of our morality and our lives themselves are still permeated with this same atmosphere of the gift, where obligation and liberty intermingle"* –, business scholars have noted the existence of continuous bonding gifts within firms. In his article "Gift Exchange", Akerloff (1982) argued that the employee makes an extra effort as a "gift" to the firm (the size of this "gift" has been measured in different experiments; see Miller and Whitford 2002) and, in exchange, the firm corresponds with a certain flexibility of rules (e.g. arriving late when the children are ill) and an above-minimum-level flat salary.

As pointed out by originally by Mauss (1950), the gift exchange involves an up to certain extent paradoxical combination of voluntarism and obligation. There is no formal enforcement for the manager to return employees' gift with another gift, but the recipient feels an obligation of acting reciprocally. In many instances, offering a first gift is a "calculated, self-interested, strategic act, designed to put the recipient in the position of returning the gift at a time and in a form that is advantageous to the original donor" (Miller and Whitford 2002, 250). The gift exchange thus becomes a de facto equilibrium in many firms.

Abraham and Prosch (2000) develop a game-theoretical approach to understand one paradox that echoes the concept of "gift exchange". In general, game theory is a good way to approach the study of transactions within firms because it allows to think like economists when price theory, such as it is the case within firms, does not apply (Gibbons: 2001). Abraham and Prosch (2000) focus on prevailing problem within firms: employees must constantly undertake asset specific-investments in their jobs. They analyze in particular the historical case of the high-tech German firm Carl Zeiss which promised – at the end of the 19th century – to fulfill almost revolutionary social-welfare obligations to its workers. The reason for this apparently non-rational altruistic behavior is that, according to Abraham and Prosch, Carl Zeiss had the opportunity to realize a (short-term) gain by laying off employees who had done an extremely costly asset-specific investment. To induce employees to make those investments, the employer – Carl Zeiss- posted a hostage *y* (a severance pay in case of dismissal) for cooperation that, in case of defection (laying off the employee for the sake of short term efficiency) transferred to the employee. Abraham and Prosch's view of severance pay is thus that of a "hostage" – a mechanism employers use to create a credible commitment in their relations with employees.

Similar problems can be found in other aspects of the employer-employee relationship (Gibbons, 2001: 334). For example, when an employee takes the decision of making a specific-to-the-relationship investment in training which will improve her productivity, she does not know if, once the additional earnings of the investment are generated, the owner will reward her appropriately (Miller, 2000; 317). The bottom line of these arguments is that there is a fundamental obstacle to efficient outcomes in firms: namely, the dominant ex post strategy for owners to expropriate the product of their employees (Falaschetti 2002: 159-160).

Gift exchange, or self-interested cooperation, does not only happen in the vertical relationship between employers and employees, but also, and this is important for organizational efficiency, in horizontal relationships among employees. As Miller (1992, 2005) finds, there are many instances in which group-based performance compensations seem to induce higher levels of effort than individually based ones. That would be the case of the garment manufacturing facility studied by Hamilton *et al.* (2003) in which moving from individual to team incentives led to an increase of productivity by about 21 percent. Another example would be Continental Airline which, in the edge of bankruptcy in 1995, imposed a system of "mutual monitoring" among employees in each airport. As the study by Knez and Simester (2001) points out, employees within an airport self-organized performance reviews every time flights were delayed in order to identify the responsible. Peer-pressure seemed to work in a quite organized and efficient way. All in all, there are few studies on team-based incentives, but as Miller (2005, 363) notes, they show "striking results" (in comparison to individual-based incentives). It is important to remark that these studies suggest that even the "losers" of moving from individual to collective performance agreements – that is, those workers with higher-than-average abilities and, thus, those who may lose revenue when moving to team-based revenue-sharing systems – seem to prefer team over individual performance assessments (Hamilton *et al.* 2003, Miller 2005).

Firms that stimulate these cooperative relations may find themselves in a competitive advantage. One pioneer of this approach – neglected during many years of dominance of a contract theory strictly focused on incentive-based individual transactions within organizations – would be Chester Barnard, who in *The Functions of the Executive* (1938) considered that a major task of any manager should be to inspire a willingness to cooperate, to take risks and to go beyond the level of effort that a narrow, self-interested analysis of the incentives would summon. Managers, similar to the reciprocity dynamics of the "gift exchange", should offer, in words of Barnard, a constant "moral example". For Knott and Hammond (2003:140), Barnard's concept of moral example would act as a signal from managers to employees that they may act truthfully and will not renege in any formal or informal agreement between them.

Controlling or Motivating? In sum, for this strand of business scholarship starting in Barnard, motivating to cooperate would be more important than preventing shirking via control. Unlike the standard principal-agent theory approach to firms, which usually focus on the idea of contract, authors within this strand of the literature emphasizes the fact that there are aspects in the internal relationships within organizations that cannot be established in a formal contract: "Every firm requires its employees to take actions that cannot be coerced – quality-improving suggestions, transaction-cost decreasing cooperation with other employees, customer-pleasing friendliness. These actions, by their very nature, cannot be induced by any formal incentive system" (Miller and Falaschetti 2001:406). This idea resembles Coase's (1937) concept of contractual incompleteness: there are behaviours that cannot be specified ex ante.

If rational workers believe that their manager will reward them as she promised, they will engage in higher levels of effort than the minimum required. Therefore, managers face a problem of credible commitment similar to the typical problems of credible commitment that politicians have in policy-making. Any solution to the organizational problems inherent to any firm, such us how to induce employee to exert higher-than-average effort levels, must be a "delicate constitutional balancing act" in which the employer must be credibly constrained from acting on her moral hazard (Miller 2005, 364).

Levi (2005) interprets Miller's theory as the existence of a "psychological contract" between superiors and subordinates which determines organizational success. This implicit contract would provide their mutual obligations and would give employees expectations about job security and fair compensation. If the psychological contract is broken, organizational efficiency may not be achieved. This is also very similar to Williamson's (1975) concept of 'relational contracts' within firms which would cover the informal agreements, unwritten codes of conduct, and norms that powerfully affect the behavior of individuals in a firm.

Negative or Positive Control? There are two symmetric problems in the relationship between employers and employees: a problem of *negative control* – employers must design incentives and sanctions to prevent employees from shirking – but also a problem of *positive control* –employers must create incentives that inspire employees to go beyond the mandatory minimum levels of effort. Two distinct branches of the principal-agent theory have dealt with these problems.

From the standard principal-agent perspective, the main problem is that of negative control, since they focus their analyses in the "agent" as source of organizational malfunctions. Firms fail because there is either an *adverse selection* of agents or because they incur in *moral hazard*. The consequence of this view is that, since the classic studies of business organizations (Berle and Means 1932, Baumol 1959), the separation of ownership and control typical of the American corporation has been seen with suspicion given its vulnerability to the problems of adverse selection and moral hazard created by managers who are not at the same time the owners. However, as Fligstein and Freeland (1995) remark, this classical theoretical prediction on the inefficiency of the American corporation has never been empirically confirmed.

The American corporation, with its separation of ownership from control, could thus resemble the standard system of separation of powers in democratic regimes, with shareholders as voters, boards of directors as legislatures, and CEOs as executives. Similar to the more credible environment for investment that a nation-state with separation of powers has over another with concentration of powers in the same hands (see Douglass North 1990, but specially his 1989 article with Weingast on the *Glorious Revolution*), corporations that separate the ownership from control may have an advantage over other types of firm structures with much more cohesive principals when it comes to create an environment of higher credibility for individuals (e.g. managers, employees).

There is some evidence pointing out in this direction. Corporations with "diffuse" ownership or a "Madisonian" checks and balances (i.e. ownership separated from control) seem to solve organizational problems of credibility better than those with concentrated ownership or without checks and balances. I would like to emphasize that the empirical evidence on this issue is limited because, first, it is intrinsically difficult to operationalize and measure a concept like organizational credibility; and, second, there are, up to my knowledge, surprisingly few studies on this issue.

One example would be Garvey and Gaston (1991), who explore which types of firms introduce deferred compensation schemes. These schemes consist of paying the employees less than their marginal products early in their careers and pay them more later in the careers. It is therefore a mechanism that partially solves the problems of adverse selection and moral hazard of employees. Only good workers will accept a low payment at the beginning, because they anticipate that once their true nature as hard-working and talented employees is revealed after years in the company, they will be rewarded by the firm. As a result, deferred compensation schemes are generally associated with corporation efficiency (Falaschetti and Miller 2001, Miller and Whitford 2001). However, not all corporations that in theory could install these schemes do so in practice. As Garvey and Gaston find, the more diffused ownership of a firm is, the more likely it is that the firm to have deferred compensation schemes. This result can be interpreted as an example of the problems of implementation that firms where powers are "concentrated" in few (or a single) owners have (Falaschetti and Miller 2001). Since, if it is true that deferred compensation schemes help solving the problem of moral hazard and adverse selection of the agent-employee, these schemes, at the same time, open the door for moral hazard of the principal-employees: "Owners have every reason to renege on the higher compensation schemes the employees come to expect late in their careers" (Miller 2005, 365; see also Lazear 1981). Similar to the historical example of those bankers who preferred to give loans to limited monarchs than to absolutist monarchs in Modern Europe because they were afraid that all-powerful monarchs would renege on their promise to return the loan depicted by North and Weingast (1989), employees joining a corporation with the equivalent of an Absolutist ruler (i.e. high ownership concentration) would trust less a deferred compensation scheme than employees joining a corporation with a relatively fragmented ownership in which it is thus more difficult for the owners to agree in reneging on the promises given to the employees.

Another example comes from Falaschetti's (2002) innovative approach to the existence of "golden parachutes" for many top executives. The traditional view of golden parachutes is that they are the result of managerial shirking, since the "incumbent management provides itself with employment contracts that transfer a lot of wealth to themselves and away from the firm" (Kreps 1990, 725) in the event the management is fired. Following this assumption, which derives from standard principal-agent theory, one should expect golden parachute contracts to happen more frequently in those firms with a more diffuse ownership. That is, the self-interested agent (e.g. manager) should take more advantage (e.g. generous golden parachutes) when it faces multiple principals (e.g. fragmented shareholders) than when it faces one single principal (e.g. one single all-powerful owner).

However, as Falaschetti shows, it is exactly the opposite what happens: golden parachutes are more likely as ownership becomes more concentrated. His interpretation is again related to the issue of credibility within organizations. The more concentrated ownership is, the easier it is going to be for the owners to take opportunistic actions against managers' interests. For instance, they can more easily break implicit contracts on deferred compensation or accept a hostile takeover bid which transfers wealth to them at the expense of the manager (who may be discharged) than fragmented owners – who face more collective action problems to undertake such opportunistic actions. Consequently, where the ownership is highly concentrated, if owners (or the owner) want to show a credible commitment to honour long-term agreements with the manager, they need to resort to "hand-tying" institutions, such as golden parachutes that increase their costs to undertake opportunistic actions (Falaschetti 2002: 160).

Horizontal Trade-Offs. Relationships between Shareholders and Managers

Historical Origins of the Conflict. The most extensively studied conflict within corporate governance is the one that opposes managers to shareholders, also known as Type I conflict (Ben Ali 2009). Apart from its intrinsic importance, another reason why this manager-shareholders conflict is so central to all discussions of corporate governance is that a large proportion of studies are done by American scholars on American firms, and this conflict is at the core of the American corporation, which pioneered the separation of ownership and control within firms more than one century ago.

Several authors (e.g. Emery 1908, 1913 Van Antwerp 1913, Piper 1915) started to underline the importance of this conflict after the 1907 bank panic.[2] In general, there was, according to the *American Economic Review,* a "renewed agitation in recent years against speculative markets and the widespread demand for their control or abolition by legislative action" (Emery 1913: 917). In particular, the "Money Trust Investigation" by the US Senate *Pujo Committee* in 1913 gave nation-wide visibility to the conflict of interests between shareholders and finance tycoons-managers.

These excerpts from another article in *American Economic Review* show the concern among economists of the time: "Many of the vast illegitimate fortunes that have debauched our citizenship are attributable directly to that cause. For many years the pretended market prices of securities of our greatest corporations have been 'rigged' and manipulated at the will of a handful of gamblers and operators, and the people of the country have been literally robbed of hundreds of millions of dollars through such transactions (Untermyer 1915: 42)…"Like every industry and profession it contains black sheep within its fold, but unlike others its regulations and practices have heretofore held out to them and to the gamblers whose tools they are temptations, inducements, and immunities of which they have freely availed themselves (…) Herein lies the anomaly of our situation –unlike anything of this kind in the civilized world (…) Why should the determination of such vital public policies be left in private and interested hands?" (ibid, 26-35).

The first legal "battle" between shareholders (or outsiders) and managers (or insiders) was thus that between keeping a private regulation – so far, the *New York Stock Exchange* was regulated, and quite strictly, by a closed 1,100-strong group – and public regulation. It was the Democrats the ones who advocated more strongly for a public regulation and, specially for a federally mandated disclosure to reduce fraud and tame insider trading. After the perceived weaknesses of private self-regulation led to the 1929 crash, New Deal Democrats passed the modern securities regulation in the 1930s – that is, the 1933 Securities Act and the 1934 Securities Exchange Act which created the Securities Exchange Commission (SEC) (Mulherin 2007: 425).

Scientific Problems in Researching Finance Regulation. Did the shareholders "win" this first battle? There has always been a fierce debate in the academia on this issue. Some well-known economists, like Stiglitz (2002) find empirical support for the hypothesis that the SEC benefited shareholders' confidence and, overall, it was in the public interests. On the contrary, other well-known economists, like Stigler (1964) have suggested that the SEC regulations did not really benefit

[2] Some scholars note that the complaints of shareholders against abusive managers should be put in the context of a sort of awakening of American citizens' consciousness as consumers entitled to rights during the highly publicized debates on the The Pure Food and Drugs Act of 1906. Those were years in which "the speculator-investor, like other consumers, became conscious of the abuses of the market place that only the producers had complained of previously" (Cowing 1958: 17).

shareholders as a whole, but mostly insiders and managers.

There is an underlying scientific problem to determine the exact effect of regulations over the interests of particular groups, because stock market regulations, such as the initial ones in the 1930s, tend to happen after a strong shock, such as the 1929 crisis (Mulherin 2007: 427). Many scientific problems emerge when studying a single event like a particular regulation. The noisy, lengthy regulatory process of a particular stock market regulation tends to give rise to endogeneity issues, confounding events, selection concerns and imprecision of data (Mulherin 2007: 428). Furthermore, we always lack a control sample or counterfactual: what would have happened in the stock market if that particular regulation had not been passed?

Something similar applies to the famous 2002 Sarbanes-Oxley Act, probably the most comprehensive reform of corporate governance since the 1930s. The Act reacted to a sequence of corporate financial scandals, including Enron in November 2001, Tyco International in January 2002 and the collapse of World.Com in June 2002. Although it represents an unprecedented intervention of federal law into the internal structure and affairs of corporations (Cioffi and Höpner 2006: 24), trying to estimate its effect on the stock market is a difficult task. The lengthy evolution of the Act through Congress over a period of several months, preceded by many months of intense discussions in the media, makes it complicated to establish when the market absorbed the news about the passage of the Act.

Very related to this, one of the most controversial debates in the literature is the one on which political party serves shareholders' interest best using as a proxy historical data on stock market returns. Almost all possible opposite (and significant!) effects have been found in the literature covering the returns of the NYSE during different periods of time since the late 19th century up to now. Democratic presidents have been associated with significantly lower (Leblang and Mukherjee 2005, Snowberg, Wolfers and Zitzewitz 2007), with statistically insignificantly lower (Mukherjee and Leblang 2007), but also with significantly but almost negligibly higher (Campbell and Li 2004), and with significantly and substantially higher returns than under Republican presidents (Hensel and Ziemba 1995; Santa-Clara and Valkanov 2003). Furthermore, stock market volatility under Democrats has been found to be both significantly higher (Freeman, Hays and Stix 2000, Herron 2000) and significantly lower (Santa-Clara and Valkanov 2003; Leblang and Mukherjee 2005) than under Republicans.[3]

Coming back to the research on the effects of regulations, the absence of neat effects of particular regulations does not mean that markets are insensitive to regulatory policy (Mulherin 2007: 431). Research has found a strong and robust impact of corporate governance structures over equity prices. Firms with a corporate structure protecting shareholder rights have, among other characteristics, higher value, higher profits, higher sales growth, and lower capital expenditures (Gompers *et al.* 2003, Shleifer and Vishny 1997). Therefore, policies regulating corporate structures *should* have a notable impact on markets. As Gompers *et al.* (2003: 35) infer from their empirical analysis, if an 11.4 percentage point difference in firm value were even partially 'caused' by each additional pro-shareholders governance provision, then "the long-run benefits of eliminating multiple provisions would be enormous." The fact that we, as social scientists, have problems to determine the exact effect of particular regulations in a given country after an extraordinary crisis (e.g. SEC in the 1930s, Sarbanes-Oxley in 2002) does not mean that regulations do not have an important effect.

Increasing Conflict since the 1980s. Since the 1980s, as mentioned above, there has been an increase in the number of hostile takeovers – which frequently tend to put the interests of shareholders and managers in clash with each other –, and, consequently, this conflict has become gradually more visible. The mechanisms of this conflict are exposed in an influential article by Shleifer

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[3] For a review of this literature, see Ederer, Fernández-Albertos and Lapuente (2008).

and Summers (1988) as well as earlier by Knoeber (1986). The starting point is that the market value of a firm tends to increase when it becomes the target of a takeover. Obviously, this increase can indicate the existence of expected efficiency gains. Yet that does not need to be the case. In many cases, it can simply indicate a redistribution – and not a creation – of value; a redistribution between managers (or other stakeholders) to shareholders, whose wealth suddenly increases. That is, accepting a hostile takeover may be opportunistic. For instance, hostile takeovers may disrupt the constant implicit or explicit agreements between owners and managers on deferred compensation. Once the acquiring firm takes the reins of a firm, "a manager may be discharged or, if retained, not paid deferred compensation due" (Knoeber 1986, 160).

Whether this fear by corporate managers is empirically grounded is not very clear, but what is undisputed in the literature is that, the rise of hostile takeovers in the 1980s has been coupled by a rise in the demands by corporate managers to policy-makers to enact new regulations to increase the defenses of firms against takeovers. Generally speaking, corporate managers have been increasingly asking for regulations that limit shareholders rights. These regulations would include different sorts of takeover defenses, but also limits to shareholders' ability to meet or act (Gompers *et al.* 2003: 1).

In the US, the Democrats have usually tried to portrait themselves as champions of the small shareholder. For instance, the SEC under the leadership of Arthur Levitt (1993-2001) – appointed by President Clinton – initiated a series of reforms to protect shareholders by improving managerial accountability and financial transparency in direct and hostile confrontation with managers' vested interests (Cioffi 2006: 21). Chief among those reforms would be the 2000 Regulation Fair Disclosure, which mandated that all publicly traded companies must disclose information to all investors at the same time, prohibiting selective disclosures which disadvantaged individual investors.

At the same time, Republicans passed, first, the Private Securities Litigation Reform Act of 1995, which weakened one of the most important enforcement mechanisms at the disposal of shareholders to hold managers accountable: the security fraud suits. The Act imposed more stringent requirements for initiating those suits. In a similar vein, the Securities Litigation Uniform Standards Act of 1998 was mostly supported by Republicans in Congress. In theory, this Act was designed to reduce "frivolous" litigation by making it harder to sue for securities fraud, but, in practice, this Act was widely perceived as strengthening the position of corporate managers at the expense of shareholders (Cioffi and Höpner 2006: 23).

Furthermore, when resigning after the Republican Presidential takeover in 2000, Levitt expressed concern about the possibility that some of his pro-shareholders actions would be revoked during the new Bush administration. He stated that the SEC with 4 out of 5 board members appointed by a Republican President would lack zeal to push accountants to resist corporate managers' pressures to make companies look better and that the new Republican administration would be strongly tempted by corporate managers to repeal the 2000 Regulation Fair Disclosure (*The New York Times*, 12-21-2000).

As a result, specially since the 1980s, the finance literature has started to challenge the traditional view that markets prefer Republicans (Allvine and O'Neill 1980, Huang 1985). There is a growing consensus in what Santa-Clara and Valkanov (2003: 1841) define as the "presidential puzzle": stock market returns are higher under Democratic than Republican administrations and these differences are explained neither by business-cycle variables nor by variations in the risk premiums assigned to each party.[4]

The 2007-2008 financial crisis. One of the most prevailing views on the reasons leading to the current financial crisis is that

[4] This is also the prevailing view among economists writing in the popular press. See, for instance, Hal Varian's "Which party in the White House means good times for stock investors?" (*The New York Times* 10/20/2003).

of the "unforeseen risk hypothesis", according to which "bank executives were faithfully working in the interests of their long-term shareholders; the poor performance of their banks during the crisis was the result of unforeseen risk of the bank's investment and trading strategy" (Bhagat and Bolton 2011, 4-5). This hypothesis is supported, first, by some studies on incentives showing that "bank CEO incentives cannot be blamed for the credit crisis or the performance of banks" (Fahlenbrach and Stulz 2011) and, second, by the vast rhetoric on the "culture of ownership", to which many banks publicly adhere. For instance, the Annual Reports by Goldman Sachs (2007) and Lehman Brothers (2005) explicitly state, respectively, that "the core of Goldman Sachs partnership was shared long-term ownership" and that "the Lehman Brothers Standard means…Fostering a culture of ownership, one full of opportunity, initiative and responsibility, where exceptional people want to build their careers" (quoted in Bhagat and Bolton 2011, 4).

Nevertheless, several scholars, and I would like to underline three important studies, have questioned this prevailing view: they point out the "political economy" problems and, in particular, the underlying conflict between shareholders and managers as the root cause of the 2007-2008 financial meltdown. The probably best known account is that by the former IMF chief economist Simon Johnson who in the book *13 bankers*, together with James Kwak, has disregarded this crisis as an exclusively technical problem in which the algorithms used by bankers or policy-makers failed. Johnson and Kwak defend the hypothesis that the crisis was the result of the abuses done by top bank executives who accumulated extraordinary levels of power.[5]

The second study would be the one by Bebchuk, Cohen and Spamann (2010) who have argued that top executive excesses – and, in particular, executive compensation programs – led to excessive risk-taking by banks. The third, most recent one, and probably most convincing empirically, is the study of the executive compensation structure in the largest 14 American financial institutions in the period 2000-2008 by Bhagat and Bolton (2011). In an original analysis, the authors argue that there are indications that top executives knew was going to happen, since they were "30 times more likely to be involved in a sell trade compared to an open market buy trade" during that period (Bhagat and Bolton 2011,4). This, and other related findings, confirms what they call the "managerial incentives hypothesis" – that is, that *"incentives generated by executive compensation programs led to excessive risk-taking by banks leading to the current financial crisis; the excessive risk-taking would benefit bank executives at the expense of the long-term shareholders"* (ibid., 3).

As a result, in order to prevent future financial crisis, among other measures,[6] these scholars ask for an extensive analysis of the underlying conflict between shareholders and managers. In particular, policy-makers should introduce regulations in the compensation structures of financial institutions aimed at giving the managers stronger incentives to work in the interests of long-term shareholders.

The "European" Conflict: Controlling versus Minority Shareholders. Unlike the more "American" Type I conflict (i.e. that between shareholders and managers), European corporations tend to suffer more of the so called Type II conflict (i.e. that between controlling and minority shareholders). This second type of conflict

[5] As the historian – and influential reviewer of this book – Niall Ferguson has noted, "too many discussions of the Great Recession present it as a purely economic phenomenon–the result of excessive leverage or errors of monetary policy or algorithms run mad. Simon Johnson was the first to point out that this was and is a crisis of political economy. His and James Kwak's analysis of the unholy inter-twining of Washington and Wall Street–a cross between the gilded age and a banana republic – is essential reading."

[6] It is important to remark here that these authors consider there are also other relevant factors explaining the financial crisis, such as, for example, the perverse incentives created by Fannie Mae and Freddie Mac.

is specially prevailing in European countries belonging to the Civil Law tradition, such as France, Spain or Italy. The reason would be that, unlike what happens in the countries of the Common Law tradition (e.g. UK and former British colonies), investors are less protected as a result of a more intrusive history of governmental regulation (La Porta *et al.* 2000).

Similar to what happens with the Type I conflict reviewed above, many scholars and policy-makers doubt of the existence of this conflict, or they even would be pleased to see a core group of shareholders enjoying special privileges at the expense of the rest of the shareholders in a corporation. For instance, think-tanks (e.g. Aspen Institute) or governmental advisory committees (e.g. in the Netherlands) have been recently launching proposals that in some extent violate the democratic principle of one share, one vote. Well-known investors, like Warren Buffet or Pete Peterson, have been advocating them. This strand of thought – or lobby – argues that long-tenure shareholders should enjoy extra voting rights or other special treatments (*The Economist,* 20-02-2009). The goal behind the creation or consolidation of a group of privileged shareholders would be, as the title of the Aspen Institute report reveals, "Overcoming Short-termism". By entrenching the privileges of those who fulfill certain criteria of longevity in a corporation we could encourage its longer-term perspective. If one stays longer as shareholder of a firm one should feel and behave more like an "owner" than those shareholders with short-term agendas like hedge-funds.

Nevertheless, giving special privileges to older shareholders – even if it may address problems of short-sightedness in a corporation – it may also open the door to other opportunistic behavior. An older and/or controlling group of shareholders may use these prerogatives to extract rents at the expense of the newer and/or minority shareholders. For example, the probably most revered of the measures to encourage long-termism, the possibility of gaining double voting rights after holding a share for a specified period (normally two years; yet sometimes up to ten years), is the object of attack by Chiraz Ben Ali (2009), who considers this measure produces "minority expropriation". Ben Ali analyzes 81 French listed firms during the 2001-2004 period and shows how those firms with double voting rights (that is, those that make a distinction between theoretically long-term-sighted owners and short-term-sighted ones), instead of encouraging long-termism, present the worst records of information disclosure – an important feature for corporate efficiency.

The more likely interpretation is that controlling shareholders want to keep their privileges, such as access to superior information, in order to extract private benefits at the expense of the mass of shareholders without access to those privileges. These results echo those of early scholars denouncing the existence of this conflict and the abuses done by controlling shareholders. For instance, that having access to private information helps controlling shareholders to obtain abnormal profits (Jaffe 1974, Finnerty 1976). This problem may be particularly acute in countries like France where up to 75% of controlling shareholders are either members of the board or managers or both (La Porta 1999).

Specially since the scandals at Enron and Worldcom, it has been increasingly evident that the access to private information by a group of controlling shareholders who often participate in the management of the firm, creates important corporate governance problems (Ben Ali 2009). This gives controlling shareholders the opportunity to expropriate minority shareholders. Yet, at the same time, it could be argued that having a group of controlling, long-sighted shareholders prevents the short-termism of short-sighted shareholders. If we stick to the theoretically democratic rule of "one share, one vote, "and we do not reward the long-term commitment of some shareholders with the corporation, our corporation may end up taking too many decisions beneficial at short term, but negative at medium-long term. The paradigmatic example of short-termism behavior would be that of activist hedge funds. Nevertheless, are we really sure that activist hedge funds behave as rent-seekers in search for short-term benefits? There is no solid evidence showing it. As a matter of fact, as *The Economist* (2009) notes, there are actually empirical indications that activist hedge funds can improve the overall performance of a firm via short campaigns to re-shape the management or strategy of firms that have been poorly managed.

Type I versus Type II Conflict. Before comparing them, it should be made clear that the distinction between these two types of conflict is frequently blurred, since in many cases controlling shareholders do in fact run the corporation, monopolizing the main managerial positions. Yet, it is still useful to keep in mind this classification of conflicts, since, as mentioned above, the traditional American firm tends to face more directly the clash of interests between few managers and a large number of highly fragmented shareholders while the European – or, to be more precise, the Non-American – firm suffers more from the conflict between controlling and minority shareholders.

In general, the consensus within the academia is that those firms where there is a high fragmentation of ownership should suffer more the conflict between shareholders and managers while those firms where there is a higher concentration of ownership should experience more the conflict between controlling and minority shareholders (Shleifer and Vishny 1986, Ben Ali 2009). In the probably most encompassing test of this issue, Fan and Wong (2002) analyze 977 companies from seven East Asian countries. They find that those firms with higher concentration of ownership offer a poorer accounting information. The reason would be that entrenched controlling shareholders release information only for self-interested purposes and the result is that the firms' reported earnings are seen as less credible by outside investors. A strong negative relationship between ownership concentration and disclosure quality has also been found for US firms (Gelb 2000).

The comparison between similar family firms and non-family firms – e.g. S&P 500 firms – allows us to compare a bit the effects of these conflicts. In family firms type I conflict is, by definition, very limited, since the members of the owning family are also managers of the firm or tend to take an active part in its management. That is, ceteris paribus, non-family firms suffer more the managers vs. shareholders conflict than family firms. On the contrary, type II conflict becomes very relevant because "entrenched managers are more likely to execute the family's plan at the expense of other shareholders" (Ben Ali 2009, 2). That is, ceteris paribus, non-family firms suffer less the controlling vs. minority shareholders conflict than family firms.

For instance, if we compare the levels of information disclosure of family firms with that of non-family firms, we are, up to certain extent, comparing the strength of each conflict. If listed family firms reported less information to their shareholders than listed non-family firms, one could conclude that type II conflict is more important than type I. If listed family firms reported more information to their shareholders than listed non-family firms, one could conclude that the type I conflict is more relevant. As a matter of fact, that is what the empirical evidence indicates: family firms disclose better quality information on the earnings of the firms, on the extent of bad news and have more informative analysts' forecasts (Ali, Chen and Radhakrishnan. 2007, Ben Ali 2009). Therefore it seems that the gains in type I conflict that a family owned firm intrinsically has vis-à-vis a non family firm exceed the intrinsic problems family owned firms have in the conflict between controlling and minority shareholders.

Future Research

The field of corporate governance is of "enormous practical importance" (Shleifer and Vishny 1997). If we were able to identify which particular corporate governance mechanisms lead to overall efficiency gains, the positive normative implications for firms and for the entire society could be enormous. Yet, as Daily, Dalton and Canella (2003) note, the field of corporate governance is at crossroads and what we don't know about which particular mechanisms of governance do really work matches what we know. Here there are some potentially interesting venues for future research which could help us to advance in what we do not know and identify win-win corporate governance mechanisms:

1. Which problem should be prioritized: having "shirking" agent (manager) or an "opportunistic" principal (owner)?

Since Adam Smith announced that the "joint stock company" (the previous equivalent of the modern corporation with separation of ownership and control) could not survive competition because of its inherent flaws, the vast majority of scholars have approached the corporation as a fundamental principal-agent problem, in which the principal (e.g. owners) needs to prevent the agent (e.g. the manager) from shirking. From the standard principal-agent perspective, the separation of ownership and control has been seen as a source of economic inefficiency (Berle and Means 1932, Baumol 1959, Marris 1964). Since firm-owners are "principals" and managers are "agents", anything that serves to reassert owners' control of firms should be applauded.

Yet, as Fligstein and Freeland (1995) remark, this neoclassical theoretical prediction has never been empirically confirmed. In addition, as mentioned above, some authors (e.g. Falaschetti 2002) find in-built advantages in firms with more separation of ownership and control. For these authors the main source of organizational problems is not the agent, but the principal, since the owners have constant temptations to act opportunistically. Future research should test, for as a large sample of firms as possible, these conflicting views: are owners-principals' moral hazard problems larger (or smaller) than manager-agents' moral hazard ones?

2. Should we study private firms as independent objects of study or within a general theory of organizations?

Having a look at the standard corporate governance literature one can see how authors hardly make reference to works outside the field of corporate governance. I think this is an important shortcoming, because there could be insights in more general theories of organization – many of them from sociology or political science – that could be helpful.

The design of public organizations has already benefited from successful designs of corporations. The most clear example would probably be the design of the so called "council-manager plan" in the US at the beginnings of the 20th century. Many US cities (i.e. similar to some Spanish towns nowadays?) were suffering extensive corruption under a "presidentialist" type of local government where the mayor accumulated both policy-making and organizational control over the implementation of policies (i.e. similar to Spanish municipalities nowadays?). In order to prevent the potential abuses by an all-powerful mayor (e.g. patronage appointments, partial policies benefiting targeted groups, direct corruption), the council-manager plan was deliberately designed to create a separation of powers within municipalities similar to the standard American Corporation. The 'founding father' of the council-manager plan, Richard S. Childs, was a business man who based his design for a new type of municipal government in the success of the private business corporation. The citizens would be the equivalent of shareholders, the municipal council would play the role of the board of directors (with the elected representatives sitting in it) and the "city manager" (an independent professional) would be the equivalent of the CEO. In order to hire and fire the city manager or CEO, representatives of the largest parties need to agree and, as a result, the city manager enjoys a relative margin of independence from short-term political pressures. Nowadays, the Western countries with relatively better indicators of quality of government at the local level have either the "council-manager plane" or versions of it.

Despite the obvious success of this learning process from private-sector to public-sector organizations (which, overall, has also been overlooked), there are very few studies that analyze other learning processes in the same direction or in the other one; that is, from "good" public organizations to firms. It would be interesting to explore other potential learning processes between both types of organizations that, so far, are analyzed by independent literatures that hardly speak to each other.

3. Managers with one hat or with two hats?

The financial crisis has brought back to the first page of the debate on corporate governance the general issue of "separation of powers" and, in particular, up to which extent we should allow "two hats"; that is, that the same individual is at the same time the CEO and the chairman of the board.

Splitting the jobs, which tends to be the rule among European firms (with the exception of France), makes sense following the very basic logic of separation of powers: how can a board prevent inefficiency and rent-seeking if the potential main responsible for that inefficiency and rent-seeking is sitting as chairman of the board? Since (as we have mentioned above), many of the corporate governance problems leading to the 2007-2008 financial crisis came as a result of excessive high-risk behavior and other abuses by relatively unconstrained and all-powerful CEOs (who were also chairman of the board or had a strong clout over it). As noted by *The Economist* (2009), one of the first reforms adopted by the American banks most affected by the crisis – such as Citigroup, Washington Mutual or Wells Fargo – was to separate the position of chairman of the board from the chief executive. That is the same demand being made by one of the most prestigious investors groups in the world, the Norwegian Norges Bank Investment Management (NBIM): If you want us to invest in you, you need to separate those positions in order to avoid the accumulation of all the power in the same hands.

Yet, despite being sympathetic to this view and, generally speaking, to the idea of creating separation of powers within all sort of organizations (in my own research, focused mostly on public administrations, I have encountered relatively substantial empirical evidence that splitting jobs and separating the interests of individuals at the top of public organizations have positive effects in terms of both organizational efficiency as well as in preventing rent-seeking), we lack robust empirical evidence on whether splitting the jobs of chairman and CEO or merging them leads to overall better performance in a firm (using any sort of proxy we can think of). So far, studies in different countries lead to opposite results. Joining the jobs of chairman and CEO in a study on US firms (Boyd 1995) was associated with better performance; on the contrary, a study on British firms (Dahya, Lonie and Power 1996) found exactly the opposite (and also statistically significant) result: ceteris paribus, "two hats" is bad for a firm.

Future research should undertake more systematic tests of this dilemma, either in its narrow form (i.e. one hat vs. two hats) or in its broader form (i.e. up to which extent should we separate the interests of managers from the board of directors'?). Again, from a theoretical point of view, it seems to me that measures developed to capture the level of separation of powers in political systems could be inspirational to try to capture levels of separation of powers within corporations. Yet, more importantly, from an empirical point of view, I think it is obvious that larger studies using more encompassing statistical methods (e.g. applying to firms the split-population models that medical scientists use to distinguish between different types of individuals, among others) and covering firms from different countries at the same time are needed in the field of corporate governance. The payoff is quite high if we are able to identify "best practices" or "best corporate features" that travel well across countries, economic sectors and types of firms.

There are many other fierce debates in corporate governance that could be improved by broader empirical analyses covering larger sets of firms. We have mentioned some of them in the introduction. I would like to conclude with another that also deserves attention. On the one hand, many scholars (and, in particular, three classic works on corporate organization: Berle and Means, 1932, Williamson, 1985, and Jensen and Meckling, 1976) consider that if outsiders or non-executive directors (NEDs) dominate the board of a corporation, monitoring the opportunistic behaviour of management would be easier and one would prevent that managers are the only evaluators of their performance. There is a large literature (although analyzing relatively few cases) pointing out that the more NEDs we have, the higher the quality of the deliberations of the board, the higher the chances of firing non-performing CEOs, among other good outcomes (e.g. Pettigrew and McNulty, 1995, Pearce and Zahra 1992). On the other hand, there are also many studies showing that the value of NEDs on corporate performance is very limited or actually negative (e.g. Agrawal and Knoeber 1996 find a negative association between the number of NEDs and firm performance using as a proxy Tobin's *Q*).

With larger studies covering different types of firms in different countries and different periods of time, we would be able to assess more clearly if, ceteris paribus, it is better to have more or less NEDs. A good starting point on how to develop future research on corporate governance are the meta-analyses by Rhoades, Rechner and Sudramurthy (2000, 2001), which allows us see which particular mechanisms of corporate governance is worthwhile to explore in larger studies. In addition, these studies allow us to formulate the questions on corporate governance in a different way. For instance, as they suggest (2000), NEDs may matter but not in a linear way as we were traditionally thinking: that is, it is not more or less NEDs vis-à-vis insiders what matters for firm performance, but to have a balance between them. Following this logic, future research on corporate governance could try to develop more accurate measures of "balance of powers" and try to see if this new measures are associated with better firm performance.

In general, as in any other science, the study of corporate governance will advance if we are capable of, to start with, formulating the appropriate research questions.

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