HYBRIDIZATION AND HETEROGENEITY ACROSS NATIONAL MODELS OF CORPORATE GOVERNANCE

By
Ruth V. Aguilera
University of Illinois at Champaign-Urbana
ruth-agu@uiuc.edu

Gregory F. Jackson
Columbia University &
Max Planck Institute for the Study of Societies
jackson@mpi-fg-koeln.mpg.de

This essay attempts to develop a corporate governance (CG) theoretical model that takes into account the social relations and institutional arrangements that shape who controls corporations, what interests corporations serve and how risks and rewards are allocated among stakeholders. Thus, we bring together two bodies of literature to build our theoretical framework: economic sociology and historical institutionalism. What the salient differences between national systems of CG are, and how they should best be conceptualized, is still hotly debated within the corporate governance literature (Gedajlovic & Shapiro, 1998; Pedersen & Thomsen, 1997; Prowse, 1995; Rubach & Sebora, 1998; Shleifer & Vishny, 1997). Few theoretical frameworks explicitly address why corporate governance patterns differ across countries and over time.

Corporate governance lies at the heart of contemporary debates about national varieties of capitalism. Globalization has led to a remarkable resurgence in the study of comparative corporate governance and provided firms with both opportunities and constraints because it introduced the *transportability* of corporate governance practices around the world, leading to an inquiry into the convergence and divergence debate of these systems.

The debate on the convergence/divergence of national systems of corporate governance is dominated by two perspectives: law and politics. On the one hand, scholars in the legal tradition claim that the degree of legal protection provided by the national system of corporate law will strongly influence the system of corporate governance (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Shareholder friendly corporate law systems allow for more active markets in terms of greater stock market valuation and higher number of listed firms. The theoretical implication of the *law* proposition is that convergence will take place if there is a convergence in law like that presently occurring in the European Union context. On the other hand, scholars in the political tradition argue that the set of corporate governance institutions in Continental Europe are *politically* inspired (Roe, 1994). Politically viable strategies confine defensive mechanisms to preserve stakeholder capitalism and contest shareholder capitalism. Thus, these political institutions serve to preserve cross-national differences. We

deliberately attempt to move beyond the theoretical discussions on convergence and divergence of corporate models, and examine instead an issue that it is rarely discussed, i.e. the *coexistence* of both divergence and convergence trends in a given country.

We begin with a brief review of the agency theory perspective and outline its challenges for understanding the social "embeddedness" of corporate governance drawing on concepts from economic sociology and historical analysis. The notion of corporate governance as a *coalition of interests* is introduced as the main theoretical framework to examine how the identities and interests of capital, labor, and management are shaped in relation to their institutional contexts. We conclude with some considerations from a comparative perspective in terms of the linkages and complementarities between corporate governance institutions, and discuss hybridization and heterogeneity across national models of corporate governance. Our perspective contributes to the analysis of *institutional change* by outlining a perspective of coevolution, where change has multiple sources rather than being driven by adaptation to a single dimension of environmental dependence.

Corporate Governance through the Agency Theory Lenses

A traditional approach for studying corporate governance has been agency theory. Shleifer and Vishny (1997) define it as the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. The firm is viewed as a nexus of contracts between principals and agents each pursuing their own interest, and where the key dilemma is aligning their conflicting interests (Coase, 1937; Jensen & Meckling, 1976; Fama, 1980; Fama & Jensen, 1983a, 1983b). Ownership and control constitute separate factors of production wherein management makes decisions and owners bear the residual risk of profit or loss. Agency theory assumes the following: owners are interested in maximizing returns at reasonable risk, distribute dividends, and raise stock prices. Conversely, management prefers growth over profits (since empire building may bring prestige or higher salaries), can be lazy or fraudulent ("shirking"), and can maintain labor or product standards above the necessary competitive minimum.

The conflict of interest between principals and agents entails incomplete contracts with agency costs that are intrinsically non-zero and may be defined as the sum of: monitoring expenditure by the principal, bonding expenditures by the agent, and residual loss. Shareholders face a variety of problems monitoring management: they have imperfect information to make qualified decisions or monitor management; contractual limits to management discretion may be difficult to enforce; and most importantly, shareholders face free rider problems where resources devoted to monitoring can be jointly appropriated by all shareholders, reducing individual incentives to actively exercise their rights. When ownership is fragmented into small holdings, shareholders with diversified portfolios face free rider problems and favor strategies of exit rather than voice.

The corporate governance literature has identified at least five possible mechanisms to reduce agency costs. First, principals can provide incentive contracts, granting managers contingent, long-term incentives to align management to shareholder interests. Second, principals are aware of the importance of reputation effects for managers who might want to exit. Third,

legal provisions such as corporate disclosure, accounting requirements, and bankruptcy rules may provide the necessary mechanisms for control and information rights to shareholders, particularly the right to appoint managers, to vote on important corporate decisions, and elect corporate boards. Forth, concentrated ownership in the form of blockholders (by banks, government, corporate groups, or families) may reduce agency costs. Lastly, efficient markets for corporate control where ownership is fragmented and most shareholders prefer strategies of exit can install effective mechanisms for monitoring and restructure underperforming firms through hostile takeovers.

Comparative research is framed in terms of the dichotomy of national mechanisms used to "solve" agency problems, given the trade-off between investment liquidity and capacity for control. Britain and the United States, countries with dispersed ownership structures, and equity financing, are viewed as market-based forms of control. Legal regulation, contractual incentives, and the takeover market are all important. By contrast, Continental Europe corporate governance relies on blockholders, particularly banks and families, as active monitors. Due to the greater capacity of blockholders to exercise direct control, these national systems of corporate governance posses fewer market-oriented rules for disclosure, less managerial incentives, and higher reliance on debt finance. A commonality between market-based and blockholder systems is their reliance on a particular form of ownership concentration as the ultimate form of control.

Corporate Governance as Coalition: The Challenge of Embeddedness

The agency theory paradigm presents a limited view of corporate governance. We discuss some of its limitations. A first set of problems relate to what Emirbayer and Goodwin (1994) conceptualized as *dyadic reductionism*. Agency theory assumes isolated bi-lateral contracts between principals and agents, focusing merely on their contractual efficiency. This view undermines the interdependencies between principals and other stakeholders. In particular, agency theory treats employment relations as exogenously determined by market institutions, while employee voice is an institutionalized part of corporate governance in most European countries. In addition, the structure of corporate ownership results in different types of business networks that condition many aspects of competition, cooperation, strategy, structure, and innovation (Whitley, 1999).

How agency problems are addressed has important consequences for efficiency. For instance, markets for corporate control may reduce the unprofitable overinvestment of free cash flow, but are known to diminish human capital formation due to breaches of trust with employees (Heinrich, 1999:28). Conversely, complementarities may arise such as when long-term supplier networks reinforce long-term employment and cooperative employment relations. It seems doubtful that the evolutionary dynamics of organizations can be explained by a single dimension of organizational dependence overlooking the linkages and complementarities between institutions (Aoki, 2001a) and the role of politics (Fligstein, 2001).

A second related set of problems stem from an *efficiency view of institutions*. Agency theory assumes that institutions result from efficient equilibrium in a neoclassical sense instead of an effectiveness assumption--where power is an underlying force in firm relationships and survival of the firm is promoted (Fligstein, 2001:177). If there is one single equilibrium, agency theory fails to account why corporate governance differs so greatly across countries in

terms of ownership patterns, corporate law systems, or employee participation models. A growing literature has illustrated the importance of power and politics in shaping corporate governance (Donnelly, Gamble, Jackson, & Parkinson, 2001; Fligstein, 1990; Fligstein & Freeland, 1995; Roe, 1994; Roy, 1997). Political outcomes do not necessarily reflect any particular dimension of transactional efficiency, but affect the distribution of power between social groups and the institutionalization of diverse organizational ideas of what the firm is.

The unmet challenge remains to conceptualize corporate governance in terms of its *embeddedness* in social relations (Granovetter, 1985). The notion of embeddedness stresses that economic activity occurs within the context of non-economic social relations. Economic action is also social action to the extent that it is oriented toward others (Weber, 1978). Wolfgang Streeck describes embeddedness as follows: "an economy is socially embedded insofar as the transactions by which it is made up are constrained by non-economic objectives or are supported by non-economic social ties" (2001: 5). An embeddedness perspective is thus relational: social relations are taken as the fundamental unit of analysis rather than ontological actors, frozen in space and time, and isolated from the social and cultural context.

We define corporate governance as the patterns of decision making and control within corporations. At the organizational level, corporate governance reflects efforts of control between capital, labor, and management as they result in diverse *coalitions* (Aoki, 1986; Cyert & March, 1963; Mintzberg, 1983). Management is often the focal actor within these interactions. The state may or may not be directly involved, but plays a critical role in defining and institutionalizing such coalitions (Cioffi & Cohen, 2000). From a coalitional perspective, corporate governance does not reflect a single criterion of rationality. Organizational goals result from coalitions among multiple actors, whose objectives may be conflicting or complementary. Only under very specific conditions, can corporations seek a single organizational goal such as maximizing profitability or shareholder value.

Coalitions are shaped by reciprocal resource dependence relationships between their constituents (Pfeffer & Salancik, 1978). For example, the influence of external shareholders depends on the firm's financial autonomy and labor bargaining power reflects the employee accumulation of firm-specific human capital. Yet, the causal logic may also run in the reverse direction: coalitions themselves define what resources become important in relation to their emerging goals. For instance, maintaining managerial autonomy is an important consideration in financial decisions such as raising external equity, taking on debt, or retaining earnings for internal finance. Coalitions, organizational goals, and resources condition each other in a circular manner.

An Institutional Approach to Corporate Governance

Coalitions are mediated by social institutions. Despite the growing attention to institutions within the social sciences, various disciplines conceptualize the nature of institutional effects quite differently and yield diverse answers to the question of national diversity (Berger & Dore, 1996; Hall & Taylor, 1996; Hall & Soskice, 2001; Hollingsworth, Schmitter, & Streeck, 1994; Powell & DiMaggio, 1991; Thelen, 1999). Economic theory accounts for institutions in terms of positive functions in coordinating economic activity (North, 1990). Political approaches regard institutions as rules or constraints on behavior imposed by powerful groups (Hall & Taylor, 1996). Finally, sociological institutionalism adds a view of

institutions as having cognitive dimensions such as common definitions of the realities that legitimize economic practices (Powell & DiMaggio, 1991). However, some threads of argument are increasingly reoccurring across disciplines that inform the particular view of institutions used in this essay.

Douglas North (1990) defines institutions as "the rules of the game," including both formal rules (e.g. law and contracts) and informal rules (e.g. norms and customs). Such rules characterize the structure of incentives and opportunities available to economic actors, particularly by impacting the transaction costs for coordinating economic activity. For this reason, it is believed that institutions influence economic performance. What does North tell us about the creation and change of institutions? Three themes appear: institutions are created by the most powerful groups to serve their own interests which depend upon ideas. Ideas are revised incrementally over time through individual and organizational learning. Institutional change thus results from both changes in relative factor prices (impacting incentives), or cumulative changes in ideas. In a more recent game-theoretic treatise, Masahiko Aoki (2001b) defines institutions as a "self-sustaining system of shared beliefs about a salient way in which the game is repeatedly played." An institution is thus a quality of social processes that can be described as a circular feedback mechanism. Institutions are therefore produced ("objectified") and reproduced as actors develop strategies that are constrained by institutionalized beliefs, and then jointly produce outcomes that reconfirm them. Hence, institutions are characterized by both a constraining and an enabling nature, in that believes constrain the actors' choices but also enable joint actions in directions that are theoretically possible although unlikely to be realized in the absence of that institution.

A common denominator among these approaches is how strategic actions come to be coordinated by common subjective beliefs. Within the framework of "actor-centered institutionalism" (Scharpf, 1997) strategic action is influenced by institutions that shape the social and political processes of how actors' interests are defined ("socially constructed"), aggregated, represented, and strategically interact across different domains. The institutional perspective does not deny that technology and resources shape organizational behavior, but it claims that responses taken by organizational actors are nonetheless mediated by the institutional context. Consistent with sociological theories, institutions not only constrain actors with given preferences, but over a longer time frame also shape the identities and interests of the actors themselves.

Institutional analysis is particularly valuable in comparative research on economic organization (Hammilton and Biggart, 1988; Biggart, 1991; Whitley, 1992a, 1992b). Different dimensions of institutionalization suggest divergent sources of economic organization and patterns of change. In effect, the study of institutional effects on economic organization follows the basic theme of Weberian analysis, namely the interdependence of interests, ideas, and institutions (Lepsius, 1990). While institutional analysis establishes a general perspective from which to view organizations, corporate governance has not been the specific focus of most research in this tradition. We propose that future research incorporates the institutional approach to corporate governance as the outcome of three organization-level coalitions between capital, labor, and management.

At the organizational level, a particularly neglected aspect of corporate governance has been the interdependencies between capital and labor. Underlying economic trade-offs may exist between wages and profits, internal investment and paying out dividends, or levels of

employment and shareholder returns. The active markets for corporate control in the U.S. create breaches of trust with other stakeholders and may undermine investments in firm-specific human capital as well as other benefits of flexible and cooperative employment relations (Shleifer & Summers, 1988). However, the interests of shareholders and employees can exist in both positive and negative sum constellations. For instance, stable blockholders and employee co-determination institutionalize a positive-sum relation between capital and labor, where minimal stable returns to shareholders balance claims to stable employment. Shareholders and employees may also form alliances to remove poorly performing management, or to demand higher corporate transparency and accountability. Thus, the coalition of capital and labor vis-a-vis management is not a zero-sum situation because increasing managerial accountability to one group may increase accountability in general, as suggested by some positive-sum views of power as a source of control. Thus, the institutional mechanisms involving (or excluding) shareholders, employees, and management in decision-making must also be viewed as interdependent.

The central claim is for national comparative research to view corporate governance in terms of its institutional linkages, tensions, and complementarities (Aoki, 2001a). *Complementarities* refer to situations where institutions become more viable in combination with specific other institutions (Hall & Soskice, 2001). The existence of complementarities should not imply efficiency. While competitive advantages may relate to complementarities, interdependence can lead to inefficient lock-in effects. Likewise, institutional interdependence may create tensions because institutions imply conflicting principles of rationality as highlighted in the Weberian tradition (Lepsius, 1990). Moreover, as tensions may have destabilizing effects on a particular organizational configuration, contradictory organizing principles may also sometimes prove to be a source of requisite variety and provide for flexible combination and recombination of organizational practices that prove economically beneficial (Stark, 2001).

National models are viewed here as influenced by multiple institutions that produce interdependent effects on organizations. But no assumption is made that such effects are complementary and lead to something like a "coherent" national model with particular efficiency traits. To the degree that a national institutional configuration gives rise to efficiency effects, these are likely to be comparative institutional advantages relative to particular strategies of production, innovation, etc. (Hall & Soskice, 2001; Whitley, 1999). A lack of tight fit between national institutions may reduce the degree to which institutions have isomorphic effects leading to homogeneity of organizations within a national case. Indeed, the degree of organizational heterogeneity or homogeneity is an open empirical question, and differs across national cases and over time. The disjuncture between institutional contexts and organizational practices create an avenue for coevolution between these two levels of analysis.

Finally, recent pressures for internationalization question the debates over the future of national diversity. In addition to the debate over a shifting towards shareholder value corporate governance, we argue that corporate governance systems are experimenting a hybridization process. *Hybridization* refers to “the ways in which forms become separated from existing practices and recombine with new forms in new practices” (Pieterse 1994, 165). Boyer, Charron, Jürgens, & Tolliday (1998) exemplify hybridization as a central concept in the study of production models in the automobile industry. They refer to how organizational

practices developed in one national space are transferred to another context, and thereby undergo adaptation.

Hybridization involves mixing shareholder or market-oriented practices developed within Anglo-American economies with nonliberal practices, particularly the institutions fostering industrial citizenship. Historically, German and Japanese corporate governance developed through an uneasy tension between liberal and nonliberal organizational principles (Jackson 2001). For example, the historical experience of "importing" U.S. institutions after World War II did not result in convergence, but in the modification of foreign practice to develop new hybrid forms with varying degrees of success (Zeitlin, 2000; Djelic, 1998). Likewise, the postwar emergence of industrial citizenship was not seen by corporations as a beneficial governance tool, but as a threat to private property and managerial discretion. The results were not coherent by design. Rather, complementarities resulted only through an unintended fit between different practices.

Hybridization points to a further consequence of growing *heterogeneity* of organizational practices within national systems. Corporations choose their corporate governance practices within the boundaries of prevailing institutional constraints and past coalitions. While national models were never entirely homogeneous, the capacity to generate a relatively isomorphic national model across companies and sectors is declining. The tensions inherent in the emerging hybrids may facilitate deviant patterns of behavior (Whitley, 1992) and greater firm-specific experimentation in combining elements of different models. Nations may retain distinct "profiles" of corporate practices, but the range of internal variation is growing particularly between large internationalized corporations and more protected domestically oriented or private corporations. Heterogeneity itself entails a de facto element of convergence.

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