

Is shareholder capitalism a defunct model for financing development?

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Since the end of the Second World War, economists and policymakers in the West have provided a succession of divergent answers to the question of how to spur the economic development of low-income countries. For the past generation, the dominant policy approach could be called the “financial market theory of development” (see, e.g., World Bank 1997). The theory was straightforward: access to capital through local financial markets would prompt entrepreneurship and economic growth while simultaneously providing a means to guide and discipline business decision making. Creating a local stock exchange would attract global investors (avoiding the need for local savings), bypass “cronyist” systems of capital allocation, and generate a system of corporate governance institutions to enforce market discipline. Financial markets, in short, were the magic pill for rapid and sustainable economic growth among emerging economies.

The model was based largely on the experience of the United States, where vast and liquid capital markets have served as an infrastructure for economic vibrancy for over a century. Vivid success stories such as Silicon Valley and the biotech industry seemed to validate a faith that access to finance (and the chance to get rich quickly through an initial public offering) could jump-start entrepreneurship that might otherwise lie dormant. Within the US, finance became central not just to business, but to the broader culture (Davis, 2009). More than half of American families were invested in the stock market by the turn of the century, and financial news became ubiquitous, as the *Wall Street Journal* grew to become the largest circulation newspaper in the country. College and retirement savings were overwhelmingly dependent on returns in the stock market, while access to mortgage financing came to depend on the good will of global investors.

The global economic crisis that ended the first decade of the 21st century has undermined the plausibility of the financial market theory of development. The US has been devastated by

its over-reliance on financial markets, as have the global producers who relied on debt-loving American consumers to buy their goods and the global investors who relied on American homeowners to pay their mortgages. The claim that financial markets are a safe and reliable means to fund economic development appears increasingly far-fetched. Meanwhile, the spectacular growth of China's economy owes little to its financial markets (in spite of the dramatic inflation and then burst of its own stock market bubble from 2006-2008). The idea of a single best model for development has become impossible to reconcile with the evidence.

In this paper, I summarize how the American model of shareholder capitalism emerged as a template for economic development in emerging economies. I then describe the fitful spread and uneven success of this model over the past generation. Next comes a critique of the model based on the two bubbles and crises of the past decade, followed by a conclusion in which I argue that there is no single best model for economic development.

The American model of shareholder capitalism

Over the course of the late 19th and 20th centuries, the United States evolved a distinctive system of corporate financing that relied heavily on markets rather than banks or other intermediaries. As a high risk/high growth emerging market in the second half of the 1800s, the US was a favored destination for foreign (particularly British) investors. The growth of a continent-wide system of privately-owned railroads was largely funded via stock and bond markets, as American commercial banks were restricted by law to relatively small size and geographic scope (Roe, 1994). The completion of an integrated national market connected by the railroads, combined with technological and managerial innovations that created economies of scale, prompted a wave of horizontal mergers in the 1890s. A consequence of this merger wave was that industry after industry was consolidated into oligopolies (Chandler, 1977). Moreover,

the merger wave among manufacturers at the turn of the century was largely orchestrated by Wall Street banks, and especially the firm of J.P. Morgan, which resulted in the most significant manufacturers being organized as publicly-traded corporations by 1903 (Roy, 1997).

This was a stark change. In 1890, there were fewer than a dozen manufacturing corporations listed on American stock markets, and the largest manufacturer around this time, Carnegie Steel, was organized as a partnership. The creation of an American economy predominantly owned by shareholders thus happened nearly overnight around the turn of the century. Prior to World War I, this new corporate system was largely overseen by investment bankers, who continued to maintain a position of control on the boards of the companies they had helped create, resulting in substantial populist suspicion of powerful “Eastern financial elites” (see Brandeis’s 1914 classic *Other Peoples’ Money: And How the Bankers Use It*). But early finance capitalism quickly gave way to a more diffuse system of dispersed ownership, particularly as the stock market boom of the 1920s drew in millions of new retail investors (Davis, 2008). By the onset of the Great Depression, Berle and Means (1932) documented the famous “separation of ownership and control” in which dispersed shareholders were powerless before the non-owning professional managers that ruled the largest corporations.

The “Berle and Means corporation,” in which ownership was dispersed and managers were seemingly free to run the business as they saw fit, was a puzzlement for economists. Jensen and Meckling (1976) asked a pointed question: why would millions of investors voluntarily hand their money over to companies run by managers who cared nothing for their interests, generation after generation? The answer was that Berle and Means must have got it wrong. Managers that didn’t care for shareholder value were punished by declining share prices, and if the price got low enough, better managers would buy enough shares to gain control of the

company, fire the incumbent managers, and renovate the business for a profit (Manne, 1965). Managers knew this, and thus took steps to reassure investors that the company would be run in their interests (that is, to increase share price). All of these steps combined to form the American system of corporate governance, in which share price was king.

The American system had several complementary elements, according to the financial economists. Boards of directors were staffed with rigorous experts who could discipline management that failed to create shareholder value. Compensation was tied to share price to provide the right incentives. Firms chose to incorporate in states with shareholder-friendly laws and to list their shares on stock markets with rigorous corporate governance standards in order to demonstrate their fitness to potential shareholders. Management chose well-reputed investment banks to underwrite their stock and bond offerings, hard-nosed accountants to audit their books, and cultivated a rigorous crowd of equity analysts to ask hard questions and keep them honest. And when all else failed, firms that failed to create shareholder value could be taken over by outsiders. Taken together, these mechanisms formed an “institutional matrix” (North, 1990) that ensured that corporations were operated to maximize shareholder value even when ownership was dispersed and individual shareholders relatively powerless. (See Davis, 2005 for a review.)

The law and economics scholars who documented the interlocking elements of the American system of corporate governance ended up producing a wiring diagram for shareholder capitalism. The flywheel of this system was a belief that the stock market was informationally efficient--that is, that the price that prevailed on the market represented the best estimate of the company's future profitability. If true, this meant that running corporations to create shareholder value was good for economic vibrancy, both at the firm level and, in principle, for the economy overall. To paraphrase Milton Friedman, if the social responsibility of business was to increase

its profits, and share price was the best measure of future profitability, then the best policy to create social value was to orient firms toward share price and to organize the economy around shareholder value maximization. And American corporate governance provided the model to make it happen, even when individual shareholders were powerless.

Now that we had a blueprint, the American corporate system could be franchised around the world like McDonald's to low-income economies. Along the way, the virtues of American capitalism would spread like a benign secular religion.

Exporting the shareholder capitalism blueprint

The financial market-based model of economic development was timely, as it appeared in the wake of the Third World debt crisis of the early 1980s that signaled the twilight of the previous development model. The history of alternative theories of development in the post-War era is reflected in the rise and fall of different kinds of capital flows (Weber, Davis, and Lounsbury, 2009). State-to-state foreign aid was the dominant form of capital flows from the West to the developing world in the 1950s and 1960s, supporting a model of state-led economic development (Armijo, 1999). In the 1970s, Western banks lent heavily to governments in developing countries, as corporations in their home countries increasingly turned to markets for their debt financing (Manzocchi, 1999). With the advent of the Mexican debt crisis in 1982, however, Western banks--particularly the American banks that had been among the largest lenders--substantially cut back on overseas lending, signaling the start of a so-called "lost decade" in economic development.

It was in this context that the financial market model emerged as a viable alternative for emerging markets (McMichael, 1996). Indeed, the very term "emerging markets" was coined by economist Antoine Van Agtmael (1984) at the International Finance Corporation to enhance the

attractiveness of “Third World” economies to outside equity investors. Rather than relying on state-to-state aid, or bank-to-state lending, emerging economies would seek to attract global investors from the private sector to directly fund their domestic businesses as a means to economic growth.

Dozens of countries opened their first domestic stock exchange in the late 1980s and 1990s, and the number of countries in the world with stock markets doubled (Weber et al., 2009). A wave of market liberalization opened domestic equity markets to foreign portfolio investors (Bekaert, Harvey, and Lundblad, 2005), and the number of emerging market country funds increased from 19 in 1986 to over 500 in 1995, along with almost 800 regional and global funds. Assets under management in these funds increased from under \$2 billion to over \$130 billion during this period (World Bank, 1997: 16).

The attraction of the model for both sides was clear. Weber et al summarize: “At the receiving end, businesses in low-income countries gain direct access to the enormous stocks of private capital generated in industrialized countries. Rather than having to rely on aid and loans mediated by political organizations, they receive capital directly from private investors. Bypassing potentially inefficient or corrupt government structures frees local entrepreneurial potential and accelerates economic growth. This encourages policymakers and corporate managers to make future-oriented decisions about the governance of their economic system...The benefits to investors are rooted in prospective growth rates unattainable in advanced economies, and the high returns to match the risks involved” (Weber et al, 2009: 1322).

Academic studies provided evidence in support of the economic benefits of financial markets (see chapter 3 of the 2000 *World Development Report* for a summary). Ross Levine and his co-authors (Levine, 1998; Levine and Zervos, 1998) published several studies documenting

the effects of financial development on broader national economic growth, and Filer, Hanousek, and Campos (1999) documented a link between stock market activity and economic growth in low- and middle-income countries. Moreover, the theory had an installed base of supporters in the World Bank and International Monetary Fund. The world was awash in mobile, investable capital, and countries that made themselves suitable outlets for foreign investment could evidently tap into it and quickly grow their domestic economies.

By late 1990s, the financial market theory of development had become a template for emerging markets. While East Asian economies that clung to old models of development suffered substantial reversals during 1997-1998, the American stock market continued its effortless upward movement. Thousands of corporations made their initial public stock offerings in the US during the 1990s. Many of them had no products, no income, and often no revenues (e.g., in biotech), but the promise of an ever-climbing stock market seemed to conjure entrepreneurs out of thin air.

Pundits declared that we had entered a new economic era in which economies would orbit financial markets the way that planets orbit the sun. Thomas Friedman's *The Lexus and the Olive Tree* was a paean to the eternal truths of this inexorable new planetary system, while Yergin and Stanislaw's *The Commanding Heights* documented what its sub-title called "The battle between government and the marketplace that is remaking the modern world." (Spoiler alert: the marketplace won.)

Yet in spite of the statistical evidence that seemed to support the economic benefits of financial markets, half of all countries never joined the bandwagon, and of those that did, dozens enjoyed no obvious benefit. While early enthusiasts at the IMF appeared to believe that stock markets were a universal positive, akin to clean water, vaccinations, and literacy, it turned out

that they were more like kidney transplants that required an appropriately-matched host in order to “take.” A famous series of studies by LaPorta et al. (1998; 1999; 2000) showed that countries whose legal systems were based on code law rather than common law tended to have smaller financial markets. The implication was that those countries unfortunate enough to have been colonized by the French or Spanish rather than the British were doomed to anemic stock markets and thus permanently lower economic growth (see Clayton, Jorgenson, and Kavajecz, 2006). Indeed, almost no former French colonies ever opened a stock exchange in the first place (with the notable exceptions of Lebanon and Vietnam). The disparities in market performance among those countries that did open exchanges were stark: while Trinidad and Tobago’s market capitalization achieved 61.4% of its GDP by 1998, Kazakhstan stalled at 0.2%. Ironically, those countries that opened domestic stock exchanges as a result of receiving concessional aid from the IMF and World Bank experienced the worst market outcomes of all, while those that opened exchanges because all their neighbors had them did the best (Weber et al., 2009).

Clearly, a stock market was not a panacea for economic development. While shareholder capitalism was initially portrayed as a voracious species of bamboo that could thrive in any environment, it turned out to be closer to a rare orchid requiring a delicately calibrated ecosystem to survive. The finding that vibrant stock markets were associated with subsequent economic growth provided little comfort for policymakers in economies that--due to accidents of geography and history--could not sustain stock markets in the first place.

An alternative to franchising shareholder capitalism to whole economies is to allow particular firms to adopt shareholder-oriented governance. John Coffee, a legal scholar at Columbia University, offered the intriguing argument that while entire economies were unlikely to adopt shareholder capitalism, in spite of its evident benefits, particular firms could do so by

offering secondary shares on American stock markets (Coffee, 1999). As the number of companies listing American Depositary Receipts (ADRs) increased to nearly 1000 over the course of the 1990s, his argument had some topical weight. By the early 2000s, all but two of the 25 largest global corporations listed their shares on American markets, regardless of their place of origin. By hypothesis, these firms would come to adopt American-style shareholder capitalism even if they had the misfortune of being headquartered in France.

The argument was intriguing but, as it happens, empirically lacking. An examination of US-listed firms domiciled in the UK, France, Germany, Japan, Chile, and Israel showed that they overwhelmingly retained the governance practices of their domestic peers: Japanese firms with ADRs had huge boards dominated by insiders, French firms listed on the New York Stock Exchange were tightly interlinked by shared directors who had all attended l'Ecole National d'Administration together, and the two dozen Chilean firms listed in the US continued to have dominant domestic owners, few analysts, and essentially no American investors (Davis and Marquis, 2005).

The exception to this generalization was Israel. Roughly 60 Israeli firms were listed in the US (following only Canada and the UK in prevalence), and in many cases these firms were incorporated in the US, funded by American venture capitalists, represented by American law firms, and indistinguishable in most respects from the typical Silicon Valley start-up, other than their mailing address. This provides a clear model for shareholder-oriented firms, albeit a model unlikely to be widely emulated across the developing world.

The financial crisis and the limits of shareholder capitalism

The theory that American-style shareholder capitalism could serve as a robust model of economic development around the world has had a rough decade since its heyday in the late

1990s. The experience of many “emerging markets” was that opening a local stock exchange and liberalizing markets to allow foreign investors was not sufficient for the market to emerge. After a generation of the financial market theory of development, nearly half of all countries still lacked a local stock market by 2005; of those that did, half had fewer than 100 listed companies (*World Development Indicators* 2008). It is clear that stock markets are not sufficient for economic vibrancy, as plenty of listless economies have stock markets. But it is also clear that stock markets may not be necessary for economic growth. Germany, until recently the world’s largest manufacturing exporter and the fourth-largest economy, has fewer listed companies than Pakistan, #48. China provides another model; Japan, still another. Economies can grow with only minimal assistance from stock markets.

Perhaps the most damaging evidence on the pathologies of shareholder capitalism came from the United States itself. The decade began with the bursting of the dot-com stock market bubble that saw the Nasdaq index decline from a high of over 5000 in the first quarter of 2000 to a low of under 1500 in the third quarter of 2001. Investors lost trillions of dollars, an amount that Shiller (2003: 14) presciently described as “roughly equivalent to the destruction of all the houses in the country.” The ensuing scandals at Enron, Worldcom, Citigroup, and elsewhere revealed that the wide-eyed enthusiasm for American corporate governance among the shareholder-value faithful was misplaced in nearly every particular. Boards of directors were not always staffed with rigorous experts capable of disciplining management. Stock-based compensation was routinely awarded with false dates to guarantee a return even if the share price stayed flat. State legislatures were highly responsive to the demands of local companies seeking protection from their investors. Investment banks worked with clients privately derided as “dogs;” accounting firms were riven with conflicts of interest that tainted their audits; equity

analysts were primarily employed to drum up business for their investment banking colleagues with relentless “strong buy” recommendations. And whatever threat of takeover corporations may have faced in the 1980s had long since been attenuated by poison pills, classified boards, and state laws friendly to local companies. The American system of corporate governance as portrayed in the finance journals turned out to be like real estate ads in Florida, bearing little resemblance to its subject in real life.

Even when shareholder-oriented corporate governance worked as advertised, the prospective economic benefits were decidedly mixed. Arguably, two casualties of the “shareholder value” movement in the US were stable employment and the manufacturing sector. The decline in both can be linked to the advent of Wall Street-driven restructurings. Just as Wall Street had created the large-scale, vertically integrated, publicly-traded corporation at the turn of the 20th century, it also ushered in the era of the modular or “network” corporation at the turn of the 21st. By giving high valuations to corporations that were heavy on intellectual assets (such as patents, trademarks, and brands) but light on physical assets and employment, the markets encouraged the adoption of the “Nike model” of production in which manufacturing and distribution is outsourced to a global supply chain. Industry after industry have been restructured in the US in favor of this model, as products from personal computers to pharmaceuticals to pet food are made by offshore contractors. In part as a result of this vertical dis-integration, manufacturing employment in the US declined by one-third between the beginning of 2001 and 2010. Although shareholders may have benefitted from this arrangement, employees did not—nor did the consumers who found their pet food to be tainted with melamine and their blood thinner adulterated with toxic chemicals (Davis, 2009: chapter 3).

By demonstrating just how badly financial bubbles can threaten the real economy, the economic crisis that began in 2008 further undermined the financial market theory of economic development. Thanks to mortgage securitization--the practice of bundling mortgage loans together and re-selling them as bonds--home ownership became increasingly accessible to those with problematic credit histories, while existing homeowners found it easy to refinance their mortgages or to take out lines of credit to extract capital gains from nominal price increases. This facilitated a bubble in house prices that was unprecedented in American history, which further encouraged homeowners to take cash out of their homes to fund consumption, or even to buy additional houses as investments. The ability to easily extract equity created a wealth effect-driven boom in consumption, lifting housing and retail sectors while creating increasingly precarious levels of household debt (Greenspan and Kennedy, 2008). When house prices inevitably reversed course, millions of homeowners found themselves owing more on their home than it was worth, and mortgage defaults created a cascading economic contraction that quickly spread around the world. As of this writing, roughly one mortgage in four in the US is underwater (that is, the house is worth less than the amount remaining on the loan)—a number expected to increase in the future.

The bursting of the housing bubble and its attendant fallout revealed the dangers of tying the well-being of an economy too closely to financial markets. While the benefits of securitization are clear, the dangers are now evident as well.

Conclusion

In the course of a decade, the financial market theory of development has gone from conventional wisdom to quaint anachronism. The experience of most of the developing world suggests that installing financial markets occasionally boosts growth, but perhaps just as often

has little effect. And the experience of the United States during the brief opening years of the 21st century shows that hypertrophied financial markets can have catastrophic effects on the real economy. Viewed from different angles, shareholder capitalism appears to be either a hothouse flower, requiring fairly specific conditions to operate effectively, or a wildfire capable of raging out of control.

At the same time, alternative models for economic development seem equally fraught outside their original context. The “Korean model” of state-led (and bank-financed) development may work well if a country has a well-educated and incorruptible corps of government bureaucrats (Evans, 1995). But what about the “Chinese model,” or the “Israeli model”? In light of the experience of the past few decades, it is prudent to be skeptical of any single model of development. Wise policymakers will draw on a diversity of models rather than hewing to the mythical “one best way.”

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