puzzling. The puzzle may be explained by the predominance of low powered incentives within large Japanese institutions or in the workings of reputations and implicit contracts in Japan.

The Japanese example brings up a very different view of large investors, namely that they are too soft rather than too tough. This can be so for several reasons. First, large investors, whether shareholders or creditors, may be soft when they themselves are corporations with their own agency problems. Charkham (1994) shows, for example, that German banks virtually control themselves. “At general meetings in recent years, Deutsche Bank held voting rights for 47.2 percent of its shares, Dresdner for 59.25 percent, and Commerzbank for 30.29 percent” (p. 36). Moreover, banks have no incentive to discipline managers, and some incentive to cater to them to get more business, as long as the firm is far away from default (Harris and Raviv (1990)). Edwards and Fischer (1994) summarize evidence suggesting that German banks are not nearly as active in corporate governance as might be expected given their lending power and control over equity votes. Second, some recent articles show that, even if they don’t suffer from their own agency problems, large investors such as banks may be too soft because they fail to terminate unprofitable projects they have invested in when continuation is preferred to liquidation (Dewatripont and Maskin (1995), Gertner, Scharfstein, and Stein (1994)). Finally, a large investor may be rich enough that he prefers to maximize private benefits of control rather than wealth. Unless he owns the entire firm, he will not internalize the cost of these control benefits to the other investors. While these arguments suggest a different set of problems with large investors, they too point to failures of large investors to force managers to maximize profits and pay them out.

VI. Specific Governance Arrangements

In the previous sections, we discussed the roles of legal protection and concentrated ownership in assuring that investors can collect their returns from firms. We have postponed the discussion of specific contractual mechanisms used to address the agency problem until this section. In particular, we now focus on debt and equity as instruments of finance. In addition, we discuss state ownership—a particular organizational form that, for reasons discussed in this article, is rarely conducive to efficiency.

A. The Debt Versus Equity Choice

Recent years saw a veritable flood of research on the debt contract as a mechanism for solving agency problems. In this new work, unlike in the Modigliani-Miller (1958) framework, where debt is associated only with a particular pattern of cash flows, the defining feature of debt is the ability of creditors to exercise control. Specifically, debt is a contract in which a borrower gets some funds from the lender, and promises to make a prespecified stream of future payments to the lender. In addition, the borrower typically promises
not to violate a range of covenants (Smith and Warner (1979)), such as
maintaining the value of assets inside the firm. If the borrower violates any
covenant, and especially if he defaults on a payment, the lender gets certain
rights, such as the ability to repossess some of the firm’s assets (collateral) or
the opportunity to throw the firm into bankruptcy. An essential feature of debt,
then, is that a failure by the borrower to adhere to the contract triggers the
transfer of some control rights from him to the lender.

The literature on debt can be usefully divided into that before Grossman-
Hart (1986), and that after. Townsend (1978) and Gale and Hellwig (1985)
consider models in which the borrower can abscond with the profits of the firm.
However, if the lender is not repaid, he has the right to investigate the books
of the firm, and grab its cash before the borrower can steal it. Thus failure to
repay triggers the transfer of control over the assets from the borrower to the
lender. Gale and Hellwig (1985) show that the optimal contract that minimizes
the expected investigation costs is a debt contract. Grossman and Hart (1982)
and Jensen (1986) model the role of debt in committing the payout of free cash
flows to investors. In Grossman and Hart (1982), in particular, default enables
creditors to deprive the manager of the benefits of control. A final important
early article, which is not cast in the agency context, but contains a highly
relevant idea, is Myers and Majluf (1984). They show that, because manage-
ment has superior information, external finance is costly. Moreover, they
argue that this adverse selection problem is minimized by the issuance of the
“safest” security, i.e., the security whose pricing is least sensitive to the
manager’s private information. Thus highly rated debt with a fairly certain
payoff stream is issued before equity, since equity is difficult to price without
knowing the precise value of the firm’s assets in place and future growth
opportunities. Debt is particularly easy to value where there is abundant
collateral, so that investors need only concern themselves with the value of the
collateral and not with the valuation of the entire firm, as equity investors
would need to.

The next generation of papers adopts the incomplete contracts framework
more explicitly, and focuses on the transfer of control from managers to
creditors. Aghion and Bolton (1992) use incomplete contract theory to charac-
terize debt as an instrument whose holders take control of the firm in a bad
state of the world. They show that if the managerial benefits of control are
higher in good states of the world, then it may be efficient for managers to have
control of assets in good states, and for creditors to have it in bad states. Their
model does not incorporate the idea that control reverts to the creditors in the
case of default as opposed to some general bad state. Bolton and Scharfstein
(1990) present a model in which upon default, creditors have enough power to
exclude the firm from the capital market, and hence stop future financing
altogether. Hart and Moore (1989, 1994a) explicitly model the idea that debt is
a contract that gives the creditor the right to repossess collateral in case of
default. Fear of such liquidation keeps money flowing from the debtors to the
creditors. Hart and Moore’s models of debt show exactly how the schedule of
debt repayments depends on what creditors can realize once they gain control.
Several other articles model the costs and benefits of the debt contract. The benefit is usually the reduction in the agency cost, such as preventing the manager from investing in negative net present value projects, or forcing him to sell assets that are worth more in alternative use. The main costs of debt are that firms may be prevented from undertaking good projects because debt covenants keep them from raising additional funds, or else they may be forced by creditors to liquidate when it is not efficient to do so. Stulz (1990), Diamond (1991), Harris and Raviv (1990), and Hart and Moore (1995) present some of the main models incorporating these ideas, whereas Lang, Ofek, and Stulz (1996) present evidence indicating that leverage indeed curtails investment by firms with poor prospects. Williamson (1988) and Shleifer and Vishny (1992) argue that liquidations might be particularly costly when alternative use of the asset is limited or when the potential buyers of the asset cannot raise funds themselves. Dewatripont and Tirole (1994) derive the optimal amount of debt in a model where the tough negotiating stance of debt holders after default deters managerial shirking ex ante. The model explains how the cash flow structure of debt as senior claimant with little upside potential makes debt holders tough on managers after a default. This makes it optimal to combine the specific form of cash flow rights of debt with contingent control of the firm in the bad state. Berglof and von Thadden (1994) similarly show why short term debt holders—who are the tough financiers in their model—should have control in the bad states. Many of these articles take advantage of Myers’ (1977) insight that debt overhang might be an effective deterrent to new financing and investment.

Because the rights of creditors are clearer, and violations of those rights are easier to verify in courts, the existing literature has anointed debt as providing better protection to outside investors than equity. However, the focus on large investors sheds new light on the relative powers of debt and equity. Specifically, debt and equity ought be compared in terms of the combination of legal protections and ease of ownership concentration that each typically provides.

First, does debt promote concentrated ownership? By far the dominant form of lending around the world is bank lending. Banks are usually large investors, who gain numerous control rights in the firm at the time of or even before default. For example, the main bank can often take physical control of the firm’s bank account—which resides at that very bank—if it misses a payment, thereby assuring fairly complete control of the firm by the bank without much involvement of the courts. This control is often bolstered by direct equity ownership in the firm, as well as a large degree of monopoly power over any future credit extended to the firm (OECD (1995)). In contrast, American, Canadian, and British firms make more extensive use of syndicated bank lending and even of public debt, in which creditors are fairly dispersed (Mayer (1990)).

But even where debt is not very concentrated, the effective legal protection afforded creditors is likely to be greater than that enjoyed by dispersed equity holders. The crucial feature of the creditors’ legal rights is that concerted action by multiple creditors is not required to take action against a delinquent
debt. The legal obligation of the firm is an obligation to each and every creditor, and any of these creditors can typically sue the firm for payment of what is owed or for sale of assets. Of course, once action is taken by one creditor, the other creditors and the courts will take action to ensure that the first creditor does not grab a disproportionate share for himself. In fact, this ability to unilaterally initiate the grab for assets in a multiple creditor situation lends the theoretical justification for bankruptcy protection.

Unlike equity, debt in a peculiar way may be tougher when it is not concentrated. If a borrower defaults on debt held by a large number of creditors, renegotiating with these creditors may be extremely difficult, and the borrower might be forced into bankruptcy (Gertner and Scharfstein (1991), Bolton and Scharfstein (1996)). In contrast, it may be easier to renegotiate with a bank. The difficulty of renegotiation, and the power of dispersed creditors, might explain why public debt is an extremely uncommon financing instrument, used only in a few developed countries, and even there much less than bank debt (Mayer (1990)).

Unlike creditors, individual shareholders are not promised any payments in return for their financial investment in the firm, although often they receive dividends at the discretion of the board of directors. Unlike creditors, individual shareholders have no claim to specific assets of the firm, and have no right to pull the collateral (one commonly studied exception is mutual funds, in which individual equity holders can force a liquidation of their pro rata share of the assets and a repayment of its value). Unlike creditors, shareholders do not even have a final date at which the firm is liquidated and the proceeds are distributed. In principle, they may never get anything back at all.

In addition to some relatively weak legal protections, the principal right that equity holders typically get is the right to vote for the board of directors. Even this right is not universal, since many countries have multiple classes of common stock, and hence equity holders with inferior voting rights get proportionately fewer votes than their financial investment in the company. Because concerted action by a large group of shareholders is required to take control via the voting mechanism, voting rights are of limited value unless they are concentrated. Most small shareholders do not even have an incentive to become informed on how to vote. Contacting and persuading a large group of small shareholders through the proxy mechanism is difficult and expensive, especially when the management stands in the way (Dodd and Warner (1983)). In contrast, when votes are concentrated—either in a large share holding block or through a takeover—they become extremely valuable, since the party that controls the concentrated votes can make virtually all corporate decisions. Concentrated equity in this respect is more powerful than concentrated debt. The value of individual shares comes from the fact that the votes attached to them are valuable to those trying to control the firm, and the protection of minority shareholders assures that those who have control must share some of the benefits with the minority (Grossman and Hart (1988), Harris and Raviv (1988)).
Because the equity holders have voting power and legal protection of minority shareholders, they have the ability to extract some payments from the managers in the form of dividends. Easterbrook (1984) articulates the agency theory of dividend payments, in which dividends are for equity what interest is for debt: pay out by the managers supported by the control rights of the financiers, except in the case of equity these control rights are the voting rights. More recently, Fluck (1995) and Myers (1995) present agency-theoretic models of dividends, based on the idea that shareholders can threaten to vote to fire managers or liquidate the firm, and therefore managers pay dividends to hold off the shareholders. These models do not explicitly address the free rider problem between shareholders; namely, how do they manage to organize themselves to pose a threat to the management when they are small and dispersed? Concentration of equity ownership, or at least the threat of such concentration, must be important to get companies to pay dividends.

One of the fundamental questions that the equity contracts raise is how—given the weakness of control rights without concentration—do firms manage to issue equity in any substantial amounts at all? Equity is the most suitable financing tool when debt contracts are difficult to enforce, i.e., when no specific collateral can be used to back credit and when near-term cash flows are insufficient to service debt payments. Young firms, and firms with intangible assets, may need to be equity financed simply because their assets have little or no liquidation value. If they are financed by debt, their managers effectively give full control to the bank from the start. This may be especially problematic when the firm’s value consists primarily of future growth opportunities, but the bank’s debt claim and unwillingness to take equity give it little interest in the upside and a distorted incentive to liquidate (Diamond (1991), Hart and Moore (1995), Dewatripont and Tirole (1994)). Rather than give away control to the bank, such firms often have highly concentrated equity ownership by the entrepreneur and a venture capitalist. This may pave the way for some dispersed outside equity ownership as long as minority rights are well enough protected.

In fact, we do observe equity financing primarily for young, growing firms, as well as for firms in rapidly growing economies, whereas mature economies and mature firms typically use bank finance when they rely on external funds at all (see Mayer (1990), Singh (1995)). In the same spirit, Titman and Wessels (1988) and Rajan and Zingales (1995) show for the United States and several OECD economies respectively that debt finance is most common for firms with tangible assets.

This analysis of equity financing still leaves an important question open: how can firms raise equity finance in countries with virtually no protection of minority investors, even if these countries are rapidly growing? Singh (1995) provides some evidence on the importance of equity financing in LDCs, although some of his data on equity financing might include privatizations and equity exchanges within industrial groups, both of which often take the form of sales of large blocks and hence need not reflect any minority purchases. One possible explanation is that, during a period of rapid economic growth, repu-
tational effects and the prospects of coming back soon to the capital market sustain good behavior until the requisite institutions and legal protections are put in place (Gomes (1996)). Investors can thus count on reputation in the short run, and legal protection in the longer run when the firm's needs for access to capital markets are smaller. Also, in some rapidly growing countries, such as Korea, the rates of return on investment may exceed the rates of appropriation by the insiders. However, another possibility is that speculative bubbles and investor overoptimism are playing an important role in equity financing in rapidly growing economies. The available evidence does not satisfactorily account for the puzzle of external equity financing in countries with only minimal legal protection of investors.

B. LBOs

A remarkable recent phenomenon in the United States that illustrates both the benefits and the costs of having large investors is leveraged buy outs. In these transactions, shareholders of a publicly owned company are bought out by a new group of investors, that usually includes old managers, a specialized buyout firm, banks and public debt holders (Jensen (1989a, 1989b)). With fewer constraints on compensation arrangements than when the firm was public, managers typically sharply increase their percentage ownership of the new company, even though they take out some of their money invested in the firm (Kaplan and Stein (1993)). The buyout firm typically buys enough equity to control the firm. Most of the financing, however, comes from banks and from buyers of subordinated public debt, which in the 1980s became known as junk bonds. In some cases, the decisions of the dispersed holders of junk debt were coordinated by its underwriters. In short, LBOs had concentrated equity ownership by managers and LBO funds, as well as debt ownership by banks, and, in effect, the holders of public debt.

Consistent with the idea that large investors reduce agency problems, the available evidence indicates that LBOs are efficient organizations. First, like other takeovers, LBOs usually buy out the old shareholders at a substantial premium, meaning at least prima facie that they were going to increase profits (DeAngelo, DeAngelo, and Rice (1984)). Second, there is direct evidence from the sample of LBOs that subsequently went public that they do increase profits (Kaplan (1989)). Third, there is some evidence that the way in which profits are increased has to do with lower agency costs. Many LBOs are targeted at highly diversified firms, which sell off many of their noncore divisions shortly after the LBO (Bhagat, Shleifer, and Vishny (1990)). If the agency problem expresses itself in the form of excessive size and diversification, then the effect of debt overhang and large shareholders is to reduce agency costs.

At the same time, LBOs illustrate the potential costs of heavily concentrated ownership. Jensen (1989a) conjectures that because LBOs are so efficient, they would become a predominant organizational form in the United States. Rapaport (1990) in contrast argues that the heavy oversight from investors might prevent future investment and growth, and hence be unattractive to the
management. Bhagat, Shleifer, and Vishny (1990) argue that the principal purpose of LBOs in the 1980's was to serve as a temporary financing tool for implementation of drastic short-run improvements, such as divestitures. Kaplan (1991) looks empirically at the question of whether LBOs are permanent organizations, or whether, alternatively, they eventually return to the public equity market. His evidence suggests that, while LBOs are not very short-lived organizations, the median firm sells equity to the public within five to six years. Although this suggests that LBOs are not permanent organizations, Kaplan also finds that even those firms issuing equity to the public retain a very heavy concentration of both debt and equity ownership. Large investors remain even when the original financing structure is too tough to be permanent.

C. Cooperatives and State Ownership

We have suggested that, in some situations, concentrated ownership may not be optimal because nonshareholder constituencies such as managers, employees, and consumers are left with too few rents, and too little incentive to make relationship-specific investments. In these situations, cooperatives might be a more efficient ownership structure (Hansmann (1988), Hart and Moore (1994b)). For example, private firms with large investors might underprovide quality or otherwise shortchange the firm's stakeholders because of their single-minded focus on profits. This logic has been used to explain why health care, child care, and even retailing are sometimes best provided by cooperatives, including consumer cooperatives. By voting on prices and quality, stakeholders achieve a better outcome than would a profit-maximizing owner.

A similar argument has been used to justify state ownership of firms. Where monopoly power, externalities, or distributional issues raise concerns, private profit-maximizing firms may fail to address these concerns. A publicly spirited politician can then improve efficiency by controlling the decisions of firms. Such social welfare arguments underlie the traditional case for state ownership of railroads, electricity, prisons, schools, health care, and many other activities (Laffont and Tirole (1993), Sappington and Stiglitz (1987)). Versions of this argument are used to justify state ownership of industrial firms as well.

With a few exceptions of activities where the argument for state ownership carries the day, such as police and prisons (Hart, Shleifer, and Vishny (1997)), the reality of state ownership is broadly inconsistent with this efficiency argument. First, state firms do not appear to serve the public interest better than private firms do. For example, in many countries state enterprises are much worse polluters than private firms. Indeed, the pollution problems are most severe in the former communist countries that were dominated by state firms (Grossman and Krueger (1993)). Second, contrary to the theory, state firms are typically extremely inefficient, and their losses result in huge drains on their countries' treasuries (Kikeri, Nellis, and Shirley (1992) and Boycko, Shleifer, and Vishny (1995) survey the relevant evidence). In their frequent
disregard of social objectives, as well as in their extreme inefficiency, the behavior of state firms is inconsistent with the efficiency justification for their existence.

The view of corporate governance taken in this article helps explain the principal elements of the behavior of state firms. While in theory these firms are controlled by the public, the de facto control rights belong to the bureaucrats. These bureaucrats can be thought of as having extremely concentrated control rights, but no significant cash flow rights because the cash flow ownership of state firms is effectively dispersed amongst the taxpayers of the country. Moreover, the bureaucrats typically have goals that are very different from social welfare, and are dictated by their political interests (Shapiro and Willig (1990), Boycko et al. (1996), Shleifer and Vishny (1994)). For example, they often cater to special interest groups that help them win elections, such as public employee trade unions, which not surprisingly typically strongly support state ownership (Lopez-de-Silanes, Shleifer, and Vishny (1997)). In sum, the bureaucrats controlling state firms have at best only an indirect concern about profits (because profits flow into the government budget), and have objectives that are very different from the social interest. Nonetheless, they have virtually complete power over these firms, and can direct them to pursue any political objective. State ownership is then an example of concentrated control with no cash flow rights and socially harmful objectives. Viewed from this perspective, the inefficiency of state firms is not at all surprising.

The recognition of enormous inefficiency of state firms, and the pressures on public budgets, have created a common response around the world in the last few years, namely privatization. In most cases, privatization replaces political control with private control by outside investors. At the same time, privatization in most countries creates concentrated private cash flow ownership to go along with control. The result of the switch to these relatively more efficient ownership structures is typically a significant improvement in performance of privatized firms (Megginson et al. (1994), Lopez-de-Silanes (1994)).

The cases where privatization does not work as well as intended can also be understood from the corporate governance perspective. For example, when firms are privatized without the creation of large investors, agency costs of managerial control may rise even when the costs of political control fall. In the United Kingdom, managers of privatized firms such as water utilities receive large wage increases (Wolfram (1995)). This outcome is not surprising, given that the controlling outside shareholders no longer exist in these firms, leaving managers with more discretion. At the same time, we doubt that the problems of managerial discretion in these companies are nearly as serious as the prior problems of political control.

Another example of postprivatization difficulties with corporate governance is Russia (Boycko et al. (1995)). For political reasons, the Russian privatization has led to controlling ownership by the management of many companies. The management has almost complete control and substantial cash flow rights, which can in principle lead to dramatically improved incentives. However, there are two problems—both of which could have been predicted from the
theory. First, the virtual absence of protection of minority shareholders makes it attractive for managers to divert resources from the firms despite their large personal cash flow stakes, since in this way they do not need to share with outside investors at all. Second, managers in many cases are not competent to restructure the privatized firms, yet in virtue of their control rights remain on the job and "consume" the benefits of control. In fact, some of the most successful privatizations in Russia have been the ones where outside investors have accumulated enough shares to either replace or otherwise control the management. Such outside investors have typically been less capable of diverting the profits for themselves than the managers, as well as better capable of maximizing these profits. The example of the Russian privatization vividly illustrates both the benefits and the costs of concentrated ownership without legal protection of minority investors.

VII. Which System is the Best?

Corporate governance mechanisms vary a great deal around the world. Firms in the United States and the United Kingdom substantially rely on legal protection of investors. Large investors are less prevalent, except that ownership is concentrated sporadically in the takeover process. In much of Continental Europe as well as in Japan, there is less reliance on elaborate legal protections, and more reliance on large investors and banks. Finally, in the rest of the world, ownership is typically heavily concentrated in families, with a few large outside investors and banks. Legal protection of investors is considerably weaker than in Japan and Germany, let alone in Britain and the United States. This diversity of systems raises the obvious question: what arrangement is the best from the viewpoint of attracting external funds to firms? In this section, we attempt to deal with this question.

A. Legal Protection and Large Investors

Our analysis leads us to conclude that both the legal protection of investors and some form of concentrated ownership are essential elements of a good corporate governance system. Large investors appear to be necessary to force managers to distribute profits. These investors require at least some basic legal rights, such as the voting rights or the power to pull collateral, to exercise their power over the management. If small investors are to be attracted to the business of financing companies, they as well require some legal protection against expropriation by both the managers and the large investors. Legal protection and large investors are complementary in an effective corporate governance system.

Indeed, the successful corporate governance systems, such as those of the United States, Germany, and Japan, rely on some combination of concentrated ownership and legal protection of investors. In the United States, both small and large shareholders are protected through an extensive system of rules that protects minority rights, allows for easy transfer of shares, keeps elections of
directors relatively uninhibited by managers, and gives shareholders extensive powers to sue directors for violations of fiduciary duty, including through class-action suits. Because of extensive bankruptcy protection of companies, however, creditors in the United States have relatively fewer rights than do creditors in Germany and Japan. These legal rules support a system of active public participation in the stock market, concentration of ownership through takeovers, but little governance by banks.

In Germany, creditors have stronger rights than they do in the United States, but shareholder rights are weaker. Germany then has a system of governance by both permanent large shareholders, for whom the existing legal rules suffice to exercise their power, and by banks, but has virtually no participation by small investors in the market. Japan falls between the United States and Germany in the degree of protection of both shareholder and creditor rights, and as a result has powerful banks and powerful long term shareholders, although neither is evidently as powerful as they are in Germany. In addition, the Japanese governance system has succeeded in attracting small investors into the stock market. Because both Germany and Japan have a system of permanent large investors, hostile takeovers are rare in both countries. Although we compare the merits of the three systems below, it is essential to remember that all of them have effective legal protection of at least some types of investors.

In much of the rest of the world, legal protection of investors is less substantial, either because laws are bad or because courts do not enforce these laws. As a consequence, firms remain family-controlled and, even in some of the richest countries, have difficulty raising outside funds, and finance most of their investment internally (Mayer 1990). Pagano, Panetta, and Zingales (1995) report the extraordinary difficulties that firms face raising outside funds in Italy. Over an 11-year period between 1982 and 1992, only 123 firms went public in Italy, compared to several thousand in the United States. Barca (1995) suggests that bank finance is also difficult to obtain. Although Mayer (1990) reports a significant amount of bank financing in Italy, most of it comes from state bank financing of state firms. In Italy, most large firms not supported by the government are family controlled and internally financed.

Although there is little systematic evidence available, most of the world appears to be more like Italy than like the United States, Germany, or Japan. A recent study of India, for example, shows that large firms tend to be family controlled, and to rely almost entirely on internal financing except when they get money from the government (Khanna and Palepu (1996)). Latin American firms also face little external corporate governance, and financing tends to be either internal or from government-controlled banks. The conclusion we draw is simple: corporate governance systems of the United States, Germany, and Japan have more in common than is typically thought, namely a combination of large investors and a legal system that protects investor rights. Corporate governance systems elsewhere are less effective because they lack the necessary legal protections.
B. Evolution of Governance Systems

The above discussion does not address the question that has interested many people, namely which of the developed corporate governance systems works the best? One could argue that, since all these systems survived and the economies prospered, the governance systems of the United States, Japan, and Germany must be about equally good. However, recent research has shown that, historically, political pressures are as important in the evolution of corporate governance systems as the economic ones.

In a much-discussed recent book, Roe (1994) argues that politics rather than economic efficiency shaped American corporate law, at least at the Federal level. Roe provides a detailed account on how the American political system systematically discouraged large investors. Banks, insurance companies, mutual funds, and pension funds were all prevented from becoming influential in corporate affairs. The hostile political response to the 1980s takeovers can be viewed as a continuation of the promanagement and antilarge-shareholder policies (Grundfest (1990), Jensen (1993)). Roe does not explain whether the extremely fine development of the legal protection of small shareholders in the United States is in part a response to the suppression of large investors, but this conclusion is actually suggested by some other work (e.g., Douglas (1940), Coffee (1991), Bhide (1993)). Roe’s conclusion is nonetheless that the American system is far from efficient because of its discouragement of the large investors.

The trouble is, the argument that the political process accommodates the powerful interests in the economy rather than maximizing social welfare applies to Germany and Japan as well. Both countries have shaped their systems of powerful banks at the end of the 19th century, during the period of rapid economic growth, and with strong support from the state (Gerschenkron (1962)). In both countries, the United States attempted to destroy the powerful financial institutions during the occupation after World War II (Adler (1949)), and in both countries it failed. Moreover, once German banks became sufficiently powerful, they discouraged the introduction of disclosure rules, prohibitions on insider trading, and other protections of minority shareholders—thus making sure that these investors never became a significant economic or political force to protect their rights. Through this political channel, the legal system has developed to accommodate the prevailing economic power, which happened to be the banks. Evolutionary arguments evidently do not adjudicate the question of which system is more efficient.

C. What Kind of Large Investors?

The question that many of the comparisons of the United States, Japan, and Germany have focused on is: what type of large investors are best? How do U.S.-style takeovers compare to more permanent large shareholders and creditors in West Germany and Japan? We do not believe that the available research provides a firm answer to this question.
Not surprisingly, the most enthusiastic assessments of American corporate governance system come from those who put greater emphasis on the role of legal protection than on that of large investors (Easterbrook and Fischel (1991), Romano (1993a)). Romano (1993a) argues that competition between U.S. states has caused the State of Delaware, where many large companies are incorporated, to adopt corporate laws that effectively serve the interests of shareholders, and thus secure effective corporate governance. Romano (1993a) even argues that Delaware adopted the most benign antitakeover legislation of all the states, thereby not precluding a future role for hostile takeovers. Easterbrook and Fischel (1991) do not discuss the role of large shareholders at all. Romano (1993b) believes that the frequently mentioned hopes that institutional investors in the United States become active, value-maximizing shareholders (e.g., Black (1990)) are exaggerated. She is also skeptical about the potential governance role of banks. In short, the bet among these scholars is on the legal protection of investors. To the extent that takeovers complement this legal protection, they are viewed as sufficient.

In contrast, advocates of the German and Japanese corporate governance system point to the benefits of permanent long term investors relative to those of takeovers. Hoshi, Kashyap, and Scharfstein (1990, 1991) show that firms with a main banking relationship in Japan go through financial distress with less economic distress and better access to financing. In addition, a large theoretical and anecdotal literature argues that the American corporate governance system, particularly takeovers, imposes short horizons on the behavior of corporate managers, and hence reduces the efficiency of investment (Stein (1988, 1989), Shleifer and Vishny (1990)). The theories and the arguments (Porter (1992)) in this area are remarkably short of any empirical support (see Poterba and Summers (1995)). Still, the superior performance of the Japanese and German economies, at least until the 1990s, has caused many to prefer their governance systems to the American one (see Aoki (1990), Roe (1993), and Charsham (1994)).

We do not think that these debates have been conclusive. True, American takeovers are a crude governance mechanism. But the U.S. economy has produced mechanisms of this kind repeatedly during the 20th century, including mergers, proxy fights, LBOs, and more recently vulture funds. Although many of these mechanisms run into political trouble, new ones keep being invented. The end of 1980s hostile takeovers probably does not spell the end of active large investors. Moreover, partly as a result of takeovers, the American economy in the 1980s went through a more radical, and possibly effective, restructuring than the economies of Japan and Western Europe. Finally, because of extensive legal protection of small investors, young American firms are able to raise capital in the stock market better than firms elsewhere in the world. It is difficult to dismiss the U.S. corporate governance system in light of these basic facts.

On the other hand, permanent large shareholders and banks, such as those dominating corporate governance in Japan and Germany, obviously have some advantages, such as the ability to influence corporate management by patient,