

# Political Determinants of Corporate Governance



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# POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE

POLITICAL CONTEXT, CORPORATE IMPACT

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Before a nation can produce, it must achieve social peace. That social peace has been reached in different nations by differing means, some of which have then been embedded in business firms, in corporate ownership patterns, and in corporate governance structures. The large publicly held, diffusely owned firm dominates business in the United States despite its infirmities, namely the frequently fragile relations between stockholders and managers. But in other economically advanced nations, ownership is not diffuse but concentrated. It is concentrated in no small measure because the delicate threads that tie managers to shareholders in the public firm fray easily in common political environments, such as those in the continental European social democracies. Social democracies press managers to stabilize employment, to forego some profit-maximizing risks with the firm, and to use up capital in place rather than to downsize when markets no longer are aligned with the firm's production capabilities. Since managers must have discretion in the public firm, how they use that discretion is crucial to stockholders, and social democratic pressures induce managers to stray farther than otherwise from their shareholders' profit-maximizing goals. Moreover, the means that align managers with diffuse stockholders in the United States— incentive compensation, hostile takeovers, and strong shareholder-wealth maximization norms—are weaker and sometimes denigrated in continental social democracies. Hence, public firms there have higher managerial agency costs, and large-block shareholding has persisted as shareholders' best remaining way to control those costs. Social democracies may enhance total social welfare, but if they do, they do so with fewer public firms than less socially responsive nations. The author therefore uncovers not only a political explanation for ownership concentration in Europe, but also a crucial political prerequisite to the rise of the public firm in the United States, namely the weakness of social democratic pressures on the American business firm.

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