

Corporate Governance and the Distribution of Wealth: A Political-Economy Perspective*

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Abstract

We present a theory in which the corporate governance structure in a country is determined by a political majority and show how this decision is related to the distribution of financial wealth. The main argument is that labor claims are exposed to undiversifiable risk, so voters with small financial stakes may prefer a corporate governance structure that reduces corporate risk taking. We discuss the inflationary experiences of different countries in the first part of the 20th century and argue that the model may explain the "great reversal" phenomenon identified by Rajan and Zingales (2003).

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1 Introduction

At the heart of the eternal normative debate in corporate governance lies the question of the relative merits of intermediated versus market influence over corporate decision making. In the popular debate, banks, traditionally the main intermediary between anonymous investors and firms, are accused of being conservative and opaque, while markets are seen as exerting excessive pressure on managerial decisions and being ruthless to stakeholders. Large owners, who control managers on behalf of small dispersed shareholders, are an important intermediate corporate-governance arrangement, but here the danger of collusion between management and large owners to the detriment of small shareholders is widely considered important.

Instead of this normative question, this paper is concerned with the positive question of how different governance systems come to exist. In recent years, a new empirical literature has interpreted the differences in governance across countries in terms of their legal origin (LaPorta, Lopez-de-Silanes, Shleifer and Vishny, 1997, 1998). Yet, as Rajan and Zingales (2003) have shown, the relative importance of capital markets and intermediaries has evolved over time. While in 1913 financial systems were relatively similar across developed countries, in subsequent decades many European countries moved to suppress equity market governance and shifted towards bank, family or state control, while others encouraged further market development, by improving regulation and strengthening control rights of dispersed equityholders.

Such large reversals in governance structure have been linked to major political shifts (Roe, 1994). In this paper we present a theory that we have developed more fully in Perotti and von Thadden (2006) of how legislative choices affect corporate governance, and offer predictions on how external shocks may induce major institutional changes in the financial market. In our theory, corporate governance affects voters because it affects corporate decisions, which have distributional effects. This brings the political process to the center of the argument, as different voters have different preferences over corporate governance arrangements.

Our theory rests on the basic insight that markets are better suited for sharing the risks of financial capital than the risks associated with firm-specific human capital. As has been argued repeatedly, human capital risk cannot be perfectly diversified, in contrast to many financial risks. This market incompleteness gives voters an incentive to influence politically not just the size of stakeholder claims, but also their riskiness. Because a compre-

hensive economy-wide redistribution of income is unfeasible or very costly in terms of efficiency, controlling labor income risk requires some influence on decentralized corporate strategies. Voters cannot influence corporate choices directly (outside the state-owned sector), but they may delegate control rights to those parties in the financial system whose interests are best aligned with their own. In our basic model, we focus on the two most important investor groups in corporate governance, equityholders and banks and then extend the argument to large shareholders.

We show that the corporate strategy choice affects individual utility differentially depending on the composition of their individual wealth. Equity control naturally chooses higher risk, higher return investments, and therefore represents best the interests of agents for whom returns to financial capital are more important than those to human capital. On the other hand, banks hold claims which are concave in profitability, and therefore are natural allies of stakeholders who want to limit corporate risk-taking. This argument is incomplete, as preferences depend on the size and form of the returns to human capital. In our companion paper we therefore endogenize the political determination of the return to human capital. While voters could choose to limit labor claims, and allow financial markets to diversify corporate risk, voters with a limited financial stake will not find this in their interest. Hence, our full theory predicts a tendency of poorer individuals to vote for high labor rents and bank control, and of richer individuals to vote for low labor rents and equity control.

We show that in a democratic voting process, when financial wealth is concentrated among richer voters, a political majority has more at stake in the form of firm-specific human capital, and therefore supports dominance by banks. If instead the median voter has a sufficient financial stake, she supports equity dominance, which results in riskier investment strategies (and possibly higher innovation), at the cost of greater individual risk-bearing.

The model has a number of empirical implications for the clustering of market development, governance and labor legislation. Perhaps the most interesting application, however, concerns its implications for the dynamics of legislation. As shareholdings by the median voters increase, for instance because of the economic success of the middle class or the emergence of capitalized pension systems, political support should move towards favoring equity markets with riskier corporate strategies and weaker labor laws. Conversely, we argue that an exogenous shock that reduces the stake of the median class in financial returns may explain the "great reversal" phenomenon in the first

half of the 20th century (Rajan and Zingales, 2003).

In the spirit of Keynes (1923), we point to a large difference across countries in terms of their inflationary experience following the First World War, after a long period of price stability. Writing at the end of the big inflationary push in several European countries, Keynes wrote in his Tract on Monetary Reform: "From 1914 to 1920 all countries experienced an expansion in the supply of money to spend relatively to the supply of things to purchase, that is to say inflation. Since 1920 those countries which have regained control of their financial situation, not content with bringing the inflation to an end, have contracted their supply of money and have experienced the fruits of deflation. Others have followed inflationary courses more riotously than before. Each process, inflation and deflation alike, has inflicted great injuries. Each has an effect in altering the distribution of wealth between different classes, inflation in this respect being the worse of the two" (Keynes, 1923, p. 60).

What is remarkable from the perspective of financial architecture is that the set of countries that maintained low inflation coincides with those described today as "outsider systems" or "market oriented" (e.g. according to the classification given by LaPorta et al., 1998). In contrast, the set of countries that "followed inflation more riotously than before" coincides with those which moved subsequently to suppress market governance and towards bank, family or state control, in particular in response to the greater uncertainty associated with free markets during the Great Depression. The mechanism that we argue is responsible for this political change is again consistent with Keynes' description of the facts: "Throughout the continent the pre-war savings of the middle class, so far as they were invested in bonds, mortgages, or bank deposits, have been largely or entirely wiped out. Nor can it be doubted that this experience must modify social psychology towards the practice of saving and investment" (Keynes, 1923, p. 67).

The remainder of this paper is organized as follows. Section 2 sketches a simplified version of the model in Perotti and von Thadden (2006). Section 3 surveys some of the empirical evidence about present and early financial structures. Section 4 discusses the economic situation after the first world war and the inflationary experience in Germany in more detail. Section 5 concludes.

2 Sketch of a Simple Model

In Perotti and von Thadden (2006), we develop a model of households and firms, which interact in a corporate governance structure that is endogenous to political decision making.¹ Here, we sketch a simplified version. Households have financial wealth and idiosyncratic human capital. Financial capital is perfectly diversified, while the return to human capital depends on the firm the household works in and cannot be insured. Households have mean-variance preferences over total wealth. Financial markets are efficient and satisfy the CAPM assumptions, so we can ignore the households' individual portfolio problem. This allows us to describe an individual household's financial position by a single number, which is its share in total financial wealth in the economy. This wealth distribution is a key component of our analysis.

Individual firm profitability is uncertain and depends on the firm's choice of strategy, which is either relatively risky or safe. The risky strategy has higher mean and higher variance than the safe strategy. In the aggregate, the law of large numbers is assumed to hold, hence total financial wealth generated by all firms in the economy is non-stochastic..

The political process determines the corporate governance structure for all firms. Corporate governance in this simple model is the right to decide about the riskiness of the firm's investment. There are three investor classes that can be dominant, dispersed equity holders, banks, and in an extension, large owners. Banks play a role, because firms have some (exogenously fixed) bank debt in their capital structure. Political decision making takes place by majority voting.

In the model, each household in its role as employee prefers less risk-taking to more, because labor income risk cannot be insured. On the capital side, dispersed equity is unambiguously in favor of the riskier strategy, because the risk is diversified away. Concentrated shareholders face a tradeoff: on the one hand, the riskier strategy yields more in expectation, on the other hand, this increases their undiversifiable risk. Banks are unambiguously in favor of less risk-taking, because they hold a concave claim on corporate profits. Since households are the ultimate capital owners, their preferences depend on how much financial capital they own (compared to their labor income, which we normalize, because we do not consider labor market imperfections). A first

¹The formal literature on the political determinants of financial structures is still fairly novel. Biais and Perotti (2002) and Pagano and Volpin (2005) are prominent examples of recent research. See Pagano and Volpin (2001) for an early survey.

insight of the analysis of the model is that the median voter theorem applies, hence that the outcome of the political choice of governance structures depends on the financial wealth of the median voter. Furthermore, as corporate risk-taking cannot be directly controlled by households, households with little financial wealth have a preference to transfer corporate control to banks. In this sense, there is a congruence of interests between labor and banks, albeit for different reasons (households hold risky claims on firms, banks in the aggregate are safe). The voters' preferences for concentrated ownership over dispersed ownership or bank control depend on the characteristics of large owners and the mean-variance tradeoff in corporate decisions.

The main prediction of our model is that if the distribution of financial wealth changes, the distribution of influence in the financial system can change. In particular, we predict that if the median voter becomes poorer financially, she will shift her support from decentralized, arm's-length financial markets to more corporatist arrangements, be it bank control or control by large concentrated owners.

3 International Comparisons, now and then

In the late 20th century, several differences between the financial structures of developed countries were clearly established. We discuss here some of these features and refer to Allen and Gale (2000) for further discussion.

As far as total financial asset holdings per GDP across countries are concerned, it is well known that these are highest in the U.S. and the U.K., and far lower, for example, in France and Germany. More importantly, the compositions of household portfolios are very different. Shares are more important in the U.K. and the U.S., while cash holdings and bank deposits dominate in France and Germany and many other European countries.

In our theoretical argument, the distribution of financial wealth plays a crucial role. For the few countries where such data are at least partially available Table 1 shows that in 1998, direct and indirect stock market participation by the median income class was around 20 % in Italy and Germany, while 2/3 of US households in the median income class owned shares, and slightly below 40 percent in the Netherlands and the U.K. Once again, the US and the UK appear to be at one extreme, and France, Italy and Germany at another, with the Netherlands close to the U.S. and the U.K.

Table 1: Proportion of households owning shares, wealth quartiles (1998)

Country	Quartile 1	Quartile 2	Quartile 3	Quartile 4	Average
Germany	6.6	17.6	22.1	29.3	18.9
Italy	3.4	10.8	19.6	38.9	18.7
Netherlands	4.4	16.9	36.8	75.9	35.1
U.K.	4.9	11.9	37.8	71.1	31.4
U.S.	4.4	38.3	66.0	86.7	48.9

Source: Guiso, Haliassos and Jappelli (2002)

For an understanding of households' lifetime wealth pension claims are among the most important assets. Here considerable institutional differences across countries are relatively well documented. The U.S., the U.K., Australia, Canada, the Netherlands, and Switzerland all have a predominantly capital-based (funded) pension system, whereas Austria, Belgium, France, Germany, and Italy have a (almost) pure pay-as-you-go pension system. In the former group of countries, the stock of pension assets is relatively large (above 40 % of GNP), while it is very low (below 10 % of GNP) in the latter group. Since funded pension systems rely on market returns for their performance, whereas pay-as-you-go systems rely on redistributive taxation, this has a considerable impact on households' appreciation of financial market returns.

The preceding remarks concern the distribution of financial assets in different countries. The structure of capital markets is also quite different across countries. Table 2 presents two standard indicators for capital market structure for a sample of 13 OECD countries. In 1970, stock market capitalization as a percentage of GDP was highest in Australia, Britain, Canada, and the U.S., and lowest in Austria, France, Germany, Italy, and Sweden, closely followed by Belgium. Exactly the same grouping obtains for the relative size of the banking sector, as measured by total deposits relative to stock market capitalization: it is smallest in the former group of countries and biggest in the latter. The Netherlands and Japan are in between, with the Netherlands closer to the Anglo-Saxon group and Japan closer to the continental European one.

Table 2 shows a clear congruence with our limited data on the distribution of financial wealth: countries in which the median class holds significant

financial wealth tend to be market-oriented, while the other countries tend to be bank-oriented. This is consistent with the comprehensive classification in Demirguc-Kunt and Levine (1999), which uses a larger number of indicators to classify countries either as market-oriented (M) or bank-oriented (B) (see Table 2).

Table 2: Market capitalization and banking assets, 1913 and 1970

	SMC/GDP 1970	Dep/SMC 1970	DKL Classification	SMC/GDP 1913	Dep/SMC 1913
Australia	0.76	50	M	0.39	95
Austria	0.09	344	B	0.76	147
Belgium	0.23	174	B	0.99	69
Canada	1.75	21	M	0.74	30
France	0.16	206	B	0.78	53
Germany	0.16	181	B	0.44	120
Italy	0.14	386	B	0.17	135
Japan	0.23	144	B	0.49	27
Netherlands	0.42	62	M	0.56	39
Sweden	0.14	357	M	0.47	147
Switzerland	0.50	138	M	0.58	160
UK	1.63	14	M	1.09	9
USA	0.66	38	M	0.39	85

Notes: SMC = Stock market capitalization, Dep = Total bank deposits.

DKL Classification: Dummy variable constructed by Demirguc-Kunt and Levine (1999), M = market-oriented, B = bank-oriented. In boldface: the 4 most strongly equity-oriented countries (highest SMC/GDP, lowest Dep/SMC)

Source: Rajan and Zingales (2003) and Demirguc-Kunt and Levine (1999)

However, the direction of causation in this relationship is not immediate. The theory of financial systems based on their legal origins (LaPorta et al.,(1998) shows that on average common-law countries nowadays have structurally better minority investor protection than countries with other legal origins. It is thus plausible that markets should be more developed and financial asset holdings more diffused in those countries. Banking then may

be more developed in civil-law countries to compensate for the lack of external equity. Interestingly, recent evidence shows that the structure of financial systems seems to have varied over the last century and that therefore other factors than legal origin must have been important.

Rajan and Zingales (2003) document that the pattern of international capital market development established after the Second World War is fairly recent and that civil law countries such as France and Belgium appear to have been markedly more financially developed than the US before World War 1. In fact, as documented in Table 2, in 1913 neither the U.S. nor Australia were particularly financially developed or market-oriented, and Canada was among the top 4 in only one category. Only Britain emerges consistently as strongly equity-market oriented. Yet, even in this seemingly clear-cut case, Franks, Mayer, and Rossi (2003) have recently shown that until the mid 20th century Britain had bad legal investor protection, when investor protection is measured along the widely accepted scale developed by LaPorta et al. (1998). On the other hand, the study of the history of incorporation laws in France by Lamoreaux and Rosenthal (2001) suggests that the protection of passive partners (i.e. investors not involved in management) was better in France than in the US in the 19th century (although rules for entry of new incorporated firms was more restrictive). Lamoreaux and Rosenthal (2001) argue that this may reflect the interests of the richer (and voting) *rentier* part of the population.

These and other data show that during the first half of the 20th century some countries (such as Britain and Switzerland) experienced relatively little change in the absolute and relative importance of their capital markets, while in others (such as Australia and the U.S.) financial markets continuously expanded, and again other countries (such as Belgium and France) experienced “great reversals” (Rajan and Zingales, 2003).

We argue that such long-term changes can be understood by looking at the evolution of economic structures and claim that the major political changes in the first half of the 20th century affected the voting populations in different countries differentially.

A structural political change that took place in almost all developed countries around World War I was a major expansion of the electoral franchise, so that a much broader fraction of the (male) population was able to vote. Until then, the tax paying class of property owners had the political power and tended to support financial market development. Belgium, Britain, France, and the Netherlands, all with strong entrepreneurial activ-

ity and well-developed financial mechanisms to support them, are probably the most important cases in point. The political change made what is now called the middle class pivotal in elections. Our key observation now is that the two world wars and the Great Depression seem to have had different redistributive effects for the middle class across countries, which shaped the perception of risks associated with free markets. While war damage hurt all income classes, differences in inflation after the war, often compounded by those of world War II, stand out when comparing different countries. Table 3 shows that the national inflationary experiences during the first half of the century differed indeed drastically across countries.

Table 3: Evolution of consumer prices 1914 - 1949

	1914	1919	1924	1929	1934	1939	1944	1949
Australia	100	133	149	161	128	144	177	222
Austria	100	2,492	HYP	-	-	-	-	-
Belgium	100		469	805	639	748		2,785
Canada	100	166	149	155	121	129	151	203
France	100	268	395	621	491	763	2,013	12,830
Germany	100	403	HYP	-	-	-	-	-
Italy	100	331	481	503	370	516	4,292	23,665
Japan	100	213	207	192	171	231	688	HYP
Netherlands	100	176	145	138	115	115	172	246
Sweden	100	257	174	170	155	172	243	267
Switzerland	100	222	169	161	129	138	208	222
UK	100	219	176	167	143	162	224	281
USA	100	193	168	165	129	134	169	229

Notes: HYP indicates hyperinflation; subsequent price indices are no longer comparable and are omitted. Countries in bold face experienced a price level increase over 25-fold during the period.

Source: Maddison (1982), based on the Statistical Yearbooks of the League of Nations

In our sample of 13 OECD countries between 1914 and 1949, the price levels either less than tripled (which corresponds to an average inflation rate of less than 3 percent) or they increased more than 27-fold (an annual rate of

more than 10 percent). Moreover, all the high-inflation countries experienced at least one sharp spurt of inflation, with hyperinflations in Austria (1922), Germany (1923), and Japan (1946). After the first world war, Belgium, France, and Italy suffered a historically sharp acceleration in inflation, which increased the price level more than 4 times in less than 10 years (between 1915 and 1924). In contrast, the UK, the Netherlands, Switzerland, Australia, Canada, and the US experienced no inflation over the same time period (although high price volatility over short sub-periods), and in fact even went through periods of deflation following the war.

In the latter group of countries, the 1929 crisis led to a tighter regulation of the financial system, which, however, typically, maintained market governance relative to the state and financial institutions. Improved legislation on minority protection and laws such as the Glass Steagall Act in the US weakened institutional influences on corporate decisions. In contrast, the countries previously ravaged by inflation responded to the Great Depression by seeking more stabilizing governance structures and greater social insurance. The result was a greater politicization of control, the restriction of markets (and often political freedom), and the emergence of other features of corporatist economies. In order to highlight the potential link between inflation and the changes in financial structure suggested by our theory, we now analyze the post-war inflationary experience in more detail.

4 Inflation

The most striking difference in the economic performance of European countries after the First World War was probably the response of their monetary policies to the legacy of the financial burden of the war and to the international recession of the post-war period. The war imposed major costs in many dimensions on all participating countries, but the greatest physical damage was borne by the central European countries on whose soil most of the hostilities took place. An illustrative example are Belgium and the Netherlands: Belgium was devastated because the German attack on France used it as a strategic deployment zone, the Netherlands were almost unharmed as they stayed neutral and no party saw a military need to invade it. The differences in physical destruction are reflected in the different evolutions of economic productivity. To give three prominent examples, the level of industrial production in France in 1920 was estimated to have been 38 percent lower than

that in 1913, to have been 45 percent lower in Germany, and to have been identical in both years in the U.K. (Wagenführ, 1933).

After 1918, all countries involved in the war rapidly dismantled wartime price and production controls and began to finance the reconversion of their economies through massive budget deficits (Aldcroft, 1977). This led to the brief boom of 1919 with strong increases in industrial production and jumps in the price level of more than 25 percent in most countries over a period of less than a year. The countries whose economies had been less affected by the war reacted to these developments very differently from the hardest-hit central European countries. From early 1920 on, the U.S. and Great Britain tightened monetary policy drastically, which, depending on the observer's point of view, brought about or did not help to prevent the world depression of 1920/21. The U.S. experienced "the sharpest price decline ... perhaps in the whole history of the United States" (Friedman and Schwartz (1963), p. 232), and industrial production contracted dramatically. By contrast, Germany and to a lesser degree France, did not counteract the inflationary boom strongly. They continued deficit- and inflation-financed spending policies, which led to an increase of industrial production between 1920 and 1922 in France by 24 percent and in Germany by 30 percent (Wagenführ (1933) - the corresponding number for Britain was a 19 percent decline). But while France managed to keep inflation from exploding, with inflation rates of less than 10 percent annually through the twenties, the economically and politically enfeebled Germany did not, went through a hyperinflation in 1923, and only stabilized its currency in 1924.

Following Keynes, we argue that the redistributive nature of inflation is key to the understanding of its impact in the first part of the 20th century: "A change in the value of money, that is to say in the level of prices, is important to society only insofar as its incidence is unequal ... Thus a change in prices and rewards, as measured in money, generally affects different classes unequally, transfers wealth from one to another, bestows affluence here and embarrassment there" (Keynes, 1923, p. 59). At least for the case of Germany, the inflation of the 1920s indeed had important redistributive effects, as we will discuss now. The discussion is based on the excellent work by Holtfrerich (1986), to which we refer for further references.

Reviewing the great inflation, the prominent German economist F. Eulenburg wrote: "There has been an appropriation of property in few but strong hands. The financial property of the middle class .. has been destroyed. This appropriation refers mainly to big business. Small and medium-size entrepre-

neurs have not been expropriated, but have been brought more strongly under the influence of big business. Because of this, the distribution of wealth has become much more unequal" (Eulenburg, 1924, p. 789). Furthermore, the author explicitly notes that the concentration of wealth reverses the broader financial participation of the middle class before World War 1: "while before the war there were good reasons to speak of 'democratic capitalism' that manifested itself in a widespread possession of capital, one now can rather speak of a capitalist oligarchy ... similar, though of a different kind, to the financial oligarchy of France" (pp. 790).

The general view of economic observers before the second world war seems to have been, following Keynes (1923), Eulenburg (1924), and Bresciani-Turroni (1931), that the inflation had made the distribution of income more unequal by impoverishing the middle class. A more differentiated picture has emerged since the 1950s in studies by Grumbach (1957), Hoffmann, Grumbach and Hesse (1965), and Holtfrerich (1980). These authors show that the statistically richer income groups of the population suffered more from the war and the following inflation than the poorer income groups, and that wages decreased much more strongly for high than for low wage groups. Accordingly, standard statistical measures of income equality such as the Pareto coefficient increased strongly between 1913 and 1925.

The resolution of this apparent contradiction lies in the role of financial wealth. Grumbach (1957), in particular, pointed out that the distribution of wealth in the first half of the 20th century in Germany was more equal than the distribution of financial wealth. Hence, the destruction of financial wealth in the great inflation worked to increase equality in the wealth distribution and thus in the distribution of income. This effect was compounded by the overall decrease in national income brought about by the war and the economic distortions of its aftermath. Holtfrerich (1980) therefore argues that "the two effects did indeed combine during the inflation. ... On December 31, 1923, taxable wealth was more equally distributed than it had been ten years earlier. The two lowest wealth classes virtually doubled their share of aggregate wealth, and the middle categories ... also enlarged their share of the total. But the categories above these ... diminished relative to the aggregate, and the proportionate decline was larger, the higher the category" (Holtfrerich, 1986, p. 276). The reason for the observed increase in wealth and income equality was therefore the loss of financial wealth by the richer part of the population. This is reflected in the drastic changes in the functional distribution of national income between 1913 and 1925 as

documented by the German *Reich's* Statistical Office. In the light of these data, "wage and salary earners may be regarded as the most unambiguous beneficiaries of the redistribution that attended the inflation. 'Real' capitalists almost maintained their share, and rentiers - i.e. recipients of unearned incomes - were the greatest losers. These consequences are perhaps also registered in the higher participation rates after the stabilization: 51.3 % of the population was actively in the labor force in 1925 as against 45.5% in 1907. Elements in the population which before the war had lived from income for which they had not worked, such as the yield on capital, now had to take up gainful activity" (Holtfrerich, 1986, pp. 269-70). Despite the disagreement about the overall meaning of redistribution, this latter, crucial, point is the same as the one raised by Eulenburg (1924) cited earlier.

The most important element of all accounts of the economic development in Germany after the first world war thus seems to be that a relatively large group of "rentiers", in Keynes's terminology, suffered big losses in terms of their financial wealth. It is this group, we argue, that became skeptical about the workings of financial markets, was forced to rely more on wage income, and therefore favored mechanisms that reduced riskiness and increased stability in the private sector.

It should be noted that we have little to say concerning the potential endogeneity of inflation. It is quite possible that the different economic and, in particular, monetary policies pursued after the first world war have been driven by some deeper underlying factors. For example, it is possible that the common law tradition whose virtues for financial market development are emphasized by LaPorta et al. (1998) has elements that foster financial stability, which are absent in some of the different versions of the civil law tradition. Also on this point, Keynes' (1923) Tract on Monetary Reform has something to say: "[I]t is not safe or fair to combine the social organization developed during the nineteenth century (and still retained) with a laissez-faire policy towards the value of money. It is not true that our former arrangements have worked well" (Keynes (1923), p. 67). This rather pessimistic assessment of the performance of British monetary policy does not seem to make the British legal system a too promising candidate for the foundation of monetary stability that has been observed in Britain after World War 1. But the legal system may still have contributed more than in other countries, and it remains to be seen which of its elements might be responsible for it.

5 Conclusions

This paper has outlined a theory in which the form of corporate governance is endogenous to the evolving political majority view. The preference of the median class is shown to depend on the distribution of financial wealth relative to human capital. This may explain large differences in corporate governance across countries as a systemic choice and as a function of the distribution of financial wealth.

The combination of high stakeholder rent protection, weak rights for shareholders, a strong role for institutions, and a relatively conservative approach to investment resembles the structure of so called corporatist economic systems, such as continental Europe or Japan. Perhaps more interestingly, the theory suggests that corporate governance systems can change as a function of the distribution of financial wealth, because a political majority will demand it. A more general conclusion is that the existence of a financially solid median class may be essential for democratic support for a market environment.

The theory proposed here also offers an explanation for the correlation of current market development with legal origin, documented by LaPorta et al. (1998). In our interpretation, the inflationary shocks following World War 1 occurred mostly as a result of fiscal crises in either defeated nations, or in Continental European countries where war damage was extensive. The Anglo-Saxon countries were allies in the war and because of geography, they escaped direct war damage (although the costs of the war were huge even for the UK, which run down much of its considerable financial strength). This helps to explain the degree of market development in civil law countries that stayed out of the war, such as the Netherlands and Switzerland. Accordingly, the emergence of insider-outsider financial systems as described in the literature on legal origin may be the result of political choices following historical events, and not exclusively of historical legal origin. As an additional corroborating piece of evidence, the political economy approach outlined here and more fully developed in Perotti and von Thadden (2006) can explain the correlation of strong financial development and weaker labor laws in developed democracies better than legal origin.

A potential challenge to our theory could be the objection that capital structure, which we have taken as exogenous, will adjust to the political framework, with the potential to undo its corporate control implications. Yet, our argument is not really tied to the formal capital structure of firms, but

rather to the distribution of influence in the economy, set by the median voter. In other words, for banks to have influence in our model it is not necessary that they finance a large share of corporate balance sheets. Equityholders, of course, may try to emancipate from bank dominance by taking on less bank debt, reducing bank equity participation in their capital structure, etc. However, if political interest (represented by the median voter) opposes this trend, there are many direct and indirect legal means that can grant banks critical influence on firm decisions.

Our approach here has been static and does not consider the potential feedback from financial system architecture to the wealth distribution. Exploring the dynamics of institutional change in a fully dynamic model is a major challenge for future research. Such a fully dynamic model promises to yield further implications for major institutional changes as the relative endowment and distribution of human and financial capital evolves over time. But already the simple model sketched in the present paper has interesting implications for the evolution of corporate governance towards a more market-oriented financial structure that seems to be currently under way in Continental Europe, in particular as regards technological change (which may alter the relative attractiveness of risky investment), demography (which may affect the evolution of pension financing), or economic and financial integration (which may induce more competition among institutional forms).

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