European model of corporate governance

Corporate governance comes into play in cases where the management of the organization has to be carried out by a manager or a group of managers who are not the owners of the organization. In essence, corporate governance is implemented by a business' financers in order to monitor and regulate the organization's utilization of their investments (Becht, Chapelle & Renneboog, 2000). In this case, the individuals hired to manage the business are paid employees and are responsible for the effective execution of the organization's processes. As a result of this arrangement, it is only natural for a separation to exist between the ownership of the organization and the management of the organization (Brickley, Coles & Jarrell, 1997). While this may appear to be a simple concept, modern day business models have allowed corporate governance models to develop rapidly over the last few years and this has led to the development of differing corporate governance models. The implementation of these corporate governance models generally varies in accordance with the region in which the organization is functioning and the nature of business of the organization.

This paper will attempt to compare and contrast the Anglo-American model and the European Model of Corporate Governance. The paper will attempt to perform this comparison in order to ascertain which of the two models more accurately reflect emerging corporate trends. Furthermore, the discussion will make international comparisons based on a variety of different economies.

Before moving on with the discussion, it is essential to come to terms with the role of the board of directors of the organization. The board of directors play a pivotal role in corporate governance models. This is because of the fact that they serve as the bridge between the stakeholders of the organization and the management team responsible for the organization's processes (Brickley, Coles & Jarrell, 1997). The sensitivity of the role of the board of directors can be judged through the fact that an extensive degree of research has been performed on the functions and composition of the board of directors. Regardless of the corporate culture in the organization, the board of directors remains present as a critical connection between the organization's human capital and the organization's stakeholders. Another reason because of which the board of directors are given extensive relevance is the fact that almost all corporate governance models look towards the board of directors when it comes to the implementation of the corporate governance models (Becht, Chapelle & Renneboog, 2000). The characteristics of the board of directors tend to vary with regard to the size of the organization, the region/regions in which the organization is functioning, the existence of the company as a listed or unlisted company and the industry/industries in which the organization is operating.

A practical example of the implementation of the European model of corporate governance and the Anglo-American model of corporate governance can be observed in the case of the US and Europe respectively (Brickley, Coles & Jarrell, 1997). In Europe, a small number of investors are capable of making pivotal investment decisions and these decisions are generally aligned with the interests of the selected investors responsible for the decisions. In comparison, the system generally followed and proffered in the US calls for the inclusion of multiple opinions and perspectives (Becht, Chapelle & Renneboog, 2000). The corporate strategy that is developed and eventually implemented is not finalized until all the investors are and shareholders are in unanimous agreement.

Management's role

In the case of the Anglo-American countries, it is often considered that the Anglo-American system of corporate governance gives unquestioning support to the management (Becht, Chapelle & Renneboog, 2000). This creates a scenario in which the management appears to have a role that is limited to the short run and does not encompass the long run. It can therefore be surmised that the management, in the case of the Anglo-American system of corporate governance, frequently communicates with the stakeholders. As a result, managers in the Anglo-American system of corporate governance try to implement strategies that will show outcomes within the span of a year or two (Brickley, Coles & Jarrell, 1997). In comparison, when the management implements the European model of corporate governance, decisions are taken with outcomes expected around five years. In such cases, the shareholders generally hold more decision making authority than that which is given to the managers. Furthermore, controlling and holding structures are significantly common in organizations making use of the European model of corporate governance. In such cases, the European model of corporate governance is also often referred to as the concentrated shareholder model because of the extensive authority that it gives to the shareholders. This concentration of ownership can often lead to the development of complications in cases where financial resources have to play their part (Becht, Chapelle & Renneboog, 2000). The number of equity suppliers is generally deficient in the European model of corporate governance because of the concentration of ownership.

Another characteristic of the European model of corporate governance that merits highlighting at this point is that which pertains to the role of the capital market. The capital market holds importance for corporate governance on account of the fact that the developments in the capital market have a direct influence on the corporate controls of the organization (Brickley, Coles & Jarrell, 1997). While the Anglo-American model of corporate governance relies heavily on the capital market and seeks to takeover threats in the capital market, the European model of corporate governance gives primary relevance to the stakeholders.

Internal Differences

Labour motivation is a critically important factor when it comes to the organization’s performance. Since labour in the European model of corporate governance is always a part of the decision making process, it is generally more motivated than the labour force in the Anglo-American model of corporate governance. Since the labour is relatively highly motivated, they choose to contribute to the organization’s development aggressively (Brickley, Coles & Jarrell, 1997). This active participation on the labour’s part tends to place a limitation on the degree to which the supervisory board can exercise authority (Hanson & Song, 2000). Influences of the labour’s active participation can generally be seen in the development of the organization’s human resource management policies.

The realist theory of codetermination understands co-determination as labour representation. Labour as the most important stakeholder group besides the shareholders should be represented and have a right to participate in the decision making on the level of the second board, i. e. the advisory board in the two-tier-board system (Hanson & Song, 2000). Co-determination as representation does not aim at consent about all matters of corporate governance. It is rather geared towards the right to participate and to be included and heard in corporate governance for the sake of workers' recognition as well as for the sake of other stakeholders of the firm because workers' participation in decision-making enhances the quality of board decisions. If the shareholders prevent the shirking of the employees of the firm according to the theory of the firm introduced by Alchian and Demsetz (1996), codetermination by labour results analogously in the prevention of shirking by shareholders and managers that causes damage to labour as shirking by employees causes damage to the shareholders. If the shareholders and/or managers do not perform optimally labour will prevent them from shirking, from not making their contractual contributions to the firm. Industrial relations are traditionally better in continental Europe than in the USA which leads to higher work place satisfaction and higher identification with the firm (Becht, Chapelle & Renneboog, 2000). These, in turn, cause higher productivity rates. In the last two decades since 1988, the process of the globalization of capital markets seemed to support the shareholder principle, not the participation principle.

In the context of globalization

As globalization continues to influence the development of the global economy, corporate governance also becomes subjected to standardization based on the successful implementation of strategies by management teams around the world (Hanson & Song, 2000). The case of General Motors and Ford presents an excellent example in this regard. General Motors and Ford have produced in Germany in huge production sites for over seventy years and did not find it unprofitable to adjust to codetermination legislation which is about 35 years old in 2008. In the European institutional setting, there is a greater complexity on the second board level that causes certain additional costs. There is, however, also the gain of additional information about the firm and of greater labour alignment with the aims of the firm as a result of labour representation in corporate governance on the level of the second board level. The participation or co-determination principle can increase corporate performance if it is understood as a principle of representation and not as a consensus principle and if it is instituted together with the control principle of hostile takeovers (Hanson & Song, 2000). Codetermination as representation of the employees on the board increases the learning capacity of the organization and also fulfils a pacification function in conflict situations within the enterprise as long as the majority vote of the shareholders or owners is safeguarded. The synthesis between the Anglo-American principle of the capital market as the market for corporate control and the German principle of co-determination as employee representation in corporate governance on the second board level is possible, even under conditions of globalization (Becht, Chapelle & Renneboog, 2000). The point to which the two systems of corporate governance, the USA and the Continental European, converge to is the strengthening of capital market control of management in Europe and the strengthening of labour representation in corporate governance in the USA.

The purpose of the firm

Another difference between the Anglo-American and the Continental European theories of corporate governance concerns the idea of the purpose of the firm (Lipton & Lorsch, 1992). The purpose of an institutional part or subsystem of a society is the major resource from which ethical analysis and decision-making draws from since the purpose of action is the most important and defining feature of an action. The purpose of any human action is the major criterion for the ethical assessment of an action or institution (Becht, Chapelle & Renneboog, 2000). The reason is that the purpose or aim of an action or institution is the central cause of an action or institution and, therefore, the central criterion for its success and value in economic, cultural and ethical respect.

Ethics gives the conditions under which value creation must take place as constraining and as enabling conditions (Hanson & Song, 2000). Value creation can take place under the neglect of the personal right of the person or of human dignity if the market conditions cause such groups of individuals to have a weak competitive position. If there is an over-supply of labour its competitive position is weak. The law might have to protect human dignity against exploitation and abuse when competition in the market does not preserve the human rights of the market participants (Becht, Chapelle & Renneboog, 2000). Situations of prisoners’ dilemma in which it is advantageous for the individual to behave opportunistically require the affirmation of ethical and legal rules independent of the utility calculus of the acting individual. Loyalty to contracts e. g. is a principle that cannot be derived from individual utility maximization for each act but must be asserted by the individual on its own merit for ethical reasons (Thompson & Wright, 1995). It can only be justified by rule utilitarianism for the general rule and not by act utilitarianism for each single act. This implies that one has the duty to be loyal to a contract even if a more advantageous contract is available instead. The non-conditional hyper-norm of the economy must be distinguished from the second order positive norms of the institutional setting of business. Some of these positive norms are sometimes suggested to be ethical or normal rules of the first order although they are in fact norms or virtues of economic organization that imply some degree of freedom of specification although their organization touches on ethical virtues, or norms of the second order. The European model of the firm emphasizes that the firm is a multi-purpose institution in which shareholder value plays the central but not the only role (Becht & Röell, 1999). The Anglo-American model of the firm emphasizes shareholder value as the only or last purpose of the firm to which the other (stakeholder) purposes are instrumental or, at least, functional. At this point, the development will go in the direction of the European model since it is more inclusive and interprets the stakeholders to be of more then instrumental value to the firm.

The recent global recession has led to the development of a scenario in which it has become imperative for organizations to exercise corporate governance. It therefore comes as no surprise that the last few years have seen a significant increase in the volume of literature on corporate governance. Furthermore, the increasing trends in globalization and the rapid developments in international businesses have placed organizations in a position where it has become crucial for them to revisit their corporate governance methodologies (Becht & Röell, 1999). These recent changes in corporate governance, and the processes of globalization that have induced them, are obviously of historic proportion, radically altering as they have economic, political and social structures. The stakes in these reforms are high and they may be literally life and death for the most vulnerable organizations.

Conclusion

In the literature of corporate governance, there has been an on-going debate about whether financial or banking models are more effective. As noted above, it is currently being argued that the key to effectiveness does not depend upon whether a country adopts one or the other model, but whether it has a well-functioning legal system which allows for the timely enforcement of contracts. If this position is correct, then the ability of developing countries to enforce a model of corporate governance may be ultimately tied to larger questions of democratic political reform a prospect which many critics feel is being undermined by the very forces of globalization promoting an Anglo American model of governance. An important question that the experience of developing countries raises – but one which it was not possible to systematically investigate in this issue – is whether individual countries acting alone will be able to effectively enforce an Anglo-American model of governance in a global economy.

The above discussion attempted to present an in depth insight into the differences between the Anglo-American model of corporate governance and the European model of corporate governance. The discussion made it clear that the fundamental distinction between the two models lies in the fact that they are present in differing business contexts (Warner, Watts & Wruck, 1988). These contexts are dictated by the shareholder identity, shareholder concentration, stock liquidity and interlocking ownership. It can be observed here that there is a difference between the two approaches in how they address the two issues of ownership and control.

The strengthening of labour representation in the American firm can improve the firm's ability to discover chances and weaknesses within the organization and to use this knowledge for increased performance. The strengthening of the market for corporate control through a more active capital market in Europe will improve the performance of management. Furthermore, globalization will move corporate governance in the direction of such a synthesis. It is likely that this model will radiate to the global market.

The question of whether economies will converge towards a common corporate Anglo-American governance system, or sustain the present diversity of institutions is one of the key issues facing countries in Europe, the Asia Pacific and throughout the rest of the world (Malette & Hogler, 1995). Lower economic growth and higher unemployment in Europe compared to the Anglo-American countries since the mid-1990s, undermined some of the confidence in Europe's social model (though by 2005 Germany had returned to its former position as the world's largest exporter). Despite the pressures towards adopting Anglo-Saxon modes of corporate governance, the divergences in both the policy and practice of corporate governance in Europe have thus far resisted any move towards European standards. However with greater market integration and the developing influence of Anglo-American institutional investors, it is possible the market will play a greater role. Yet debates on company law harmonization in the European Union have been held up by countries not wishing to see elements of their own systems of corporate governance disappear in the process. One explanation for this impasse is the institutional complementarily thesis which justifies the continuing diversity of systems, rejecting the ‘ one-best-way’ strategy adopted by the ‘ convergence thesis.’ Instead a plurality of models is assumed, each corresponding to local circumstances, supported by a cluster of social norms and regulation, enabling balanced economic development. It can also be argued that the Anglo-American models can serve as an effective method for breaking unhealthy state business relationships and imposing more discipline on domestic corporations (Yermack, 1996).

The diversity of corporate models is valuable and is rooted in societal characteristics that together shape the competitiveness of the different models. Though shareholder value may be gaining ground due to the influence of Anglo-Saxon institutional investors, a stakeholder approach is closer to the reality of European social democracies, and the outcome of the confrontation between the two competing philosophies is highly uncertain. It is unlikely that imported Anglo-Saxon capital market related features of corporate governance will work well with Continental labor-related aspects of corporate governance as represented in supervisory boards. It is likely any such European compromise would be more unstable than existing systems. The attractiveness of the Anglo-American finance and governance institutions permeated with inequality and subject to recurrent severe market cycles and financial crisis is open to question as a model for universal applicability. Indeed the damaging consequences of the 2008 financial crisis will impact severely upon the world economy, and could well dislodge the faith that the market based governance system is the only rational and efficient one for the future. It is more likely that solutions will be found to pressing problems of equity, sustainability and innovation in a diversity of finance and governance systems, responsive to deeper and wider concerns than the self-interest of the executives who control corporations, financial institutions and hedge funds.

The paper served to clarify that while the Anglo-American model of corporate governance seeks to implement external discipline methodologies. This entails the concentration of the organization’s resources and attention towards elements such as proxy fights in the competitive landscape, handling liability management claims and the sustenance of management reputation. The Anglo-American model of corporate governance is somewhat aggressive and appears to be a model that continuously demands the organization to function as a challenger in the competitive landscape.

In comparison, the European model of corporate governance seeks to make use of extensive alignment between the organization’s stakeholders. The external methodologies brought into use by the European model of corporate governance tend to increase coordination and communication across the organization in an attempt to streamline the organization’s functions in accordance with the organization’s objectives. In addition, the European model of corporate governance also seeks to ensure that the organization’s objectives are understood and that the management, stakeholders and board of directors are in mutual agreement on the objectives of the organization.

The comparison of the two corporate governance models has served to reveal that the Anglo-American model of corporate governance is an aggressive corporate governance model and in order to exercise the Anglo-American model of corporate governance the organization needs to have a strong foundation (Wolfenzon, 1998). This is because of the fact that the Anglo-American model of corporate governance often requires the managers to make decisions that are in favour of their own perspectives and require over-investment. In this case, the managers do not seek the approval of external stakeholders and proceed with the implementation of their decisions. In this regard, the European model of corporate governance comes forth as the preferred corporate governance model. This is because of the fact that the European model of corporate governance gives the organization the margin of deciding on an orientation that is best suited for the competitive landscape in which the organization is functioning (Wolfenzon, 1998). While the Anglo American model of corporate governance demands that the organization plays aggressively continuously, the European model of corporate governance gives the organization the margin it needs to adapt to changing needs. As a result, the organization can choose to function passively and steadily when it chooses; and functions aggressively when it chooses. In essence, the increased communication and coordination between the strategic, operational and tactical elements of the organization allows the organization to ensure that it does not get exposed to any high-risk scenarios.

The recommendation of the European model of corporate governance is based on the pretext that recent global economic trends have proved that it is feasible for organizations to adopt an organization that minimizes their exposure to risk. Managerial reputation and status cannot be given importance over the organization’s sustained growth because most organizations that have been successful in the last few decades have chosen to follow their expansion strategies with consistency; regardless of the speed at which they grew. While some organizations chose to grow rapidly by intentionally engaging in high-risk investments, others chose to implement the European model of corporate governance by reducing their risk exposure. Organizations such as these proceeded by studying internal and external scenarios closely before finalizing and implementing a strategy. It is because of this reason that such organizations were able to minimize the degree to which they were impacted by the recent global recession.

It can be observed that the European model of corporate governance requires the management to engage in a level of coordination that the Anglo-American model of corporate governance does not call for. As a result, the European model of corporate governance places the management in a position where every decision that materializes into action is of a nature such that is supports the organization and is not influenced by a desire to drive up managerial reputation and status.

Another key reason because of which the European model of corporate governance is recommended over the Anglo-American model of corporate governance is because the European model of corporate governance satisfies the need for the generation of shareholder profitability. The Anglo-American model of corporate governance does not give primary relevance to shareholder profitability because the authority to make investment decisions is placed and limited in the hands of a few individuals. In comparison to this, the European model of corporate governance places the organization in a position where the generation of shareholder profitability enables the organization to attract more investors. In this regard, it would be just to bring the paper to a concluding note with the statement that the European model of corporate governance accurately reflects emerging corporate trends. The examples and elaborations presented in the above discussion make it clear that the European model of corporate governance responds far more adequately to modern day business needs than the Anglo-American model of corporate governance.