

# Taxonomies of Corporate Governance Systems

## Market-based vs bank-based

The British economist John Hicks and the American business historian Alfred Chandler Jr were the first to attempt to categorise the different systems of capitalism. Hicks (1969) <sup>1</sup> distinguished between **market-based economies** and **bank-based economies**, a key framework in comparative political economy and financial systems analysis. Researchers like Franklin Allen and Douglas Gale expanded the concept.

### Key differences

The key difference lies in how economic resources are mobilised and allocated.

|                             | Market-Based Economies                                                                                                                                  | Bank-Based Economies                                                                                                                                         |
|-----------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Financing method            | Savers invest directly in securities like stocks or bonds issued by companies or governments, bypassing banks.                                          | Savers deposit funds in banks, which then lend these funds to businesses or individuals.                                                                     |
| Dominant institutions       | Stock exchanges, investment funds, hedge funds.                                                                                                         | Commercial banks, development banks, credit unions.                                                                                                          |
| Financial intermediaries    | Financial markets (like stock exchanges) play a crucial role in facilitating the trading and pricing of these securities.                               | Banks act as intermediaries, gathering deposits and providing loans, facilitating the flow of funds between savers and borrowers.                            |
| Logic of capital allocation | The allocation of capital is driven by supply and demand, with investors and borrowers interacting freely based on their assessment of risk and return. | Banks often have close relationships with borrowers, monitoring their activities and making lending decisions based on their evaluation of creditworthiness. |
| Corporate governance        | Shareholder-driven (focus on stock prices).                                                                                                             | Stakeholder-driven (banks monitor firms closely).                                                                                                            |
| Risk assessment             | Risks are dispersed across many investors. More liquidity, but higher volatility.                                                                       | Risks are concentrated in banks' balance sheets. Long-term relationships, less volatility.                                                                   |
| Examples                    | Great Britain, United States                                                                                                                            | Germany, Japan                                                                                                                                               |

Many authors stress the advantages that banks have over markets in financing the expansion of existing firms, in promoting the establishment of new firms, and in efficiently allocating capital. Others, however, emphasise the comparative merits of markets. Historically, empirical research on the bank-based versus market-based debate has centred on Germany and Japan as bank-based systems and the United States and Great Britain as market-based financial systems.

## Views in favour of the bank-based economy

**Gerschenkron (1962)**<sup>2</sup> argues that banks more effectively finance industrial expansion than markets in underdeveloped

economies: powerful banks can induce firms to reveal information and pay debts better than atomistic markets. Meanwhile, state-owned banks can overcome market failures and funnel domestic savings to strategically important projects.

**Stulz (2000)**<sup>3</sup> argues that banks are more effective in providing external resources to new, innovative activities that require staged financing because banks can credibly commit to making additional funding available as the project develops.

Banks can also effectively monitor firms. For example, **Bhide (1993)**<sup>4</sup> shows that, in a liquid market, investors can easily liquidate shares; consequently, they have few incentives to expend resources to monitor managers. In contrast, **Diamond (1984)**'s model of delegated monitoring<sup>5</sup> shows that, a strong role of banks as providers of finance to corporations potentially creates value as banks benefit from synergies when monitoring other companies and hence provide monitoring at a lower cost than if debt were in the form of traded securities that are widely held.

Similar to monitoring is the research cost. **Stiglitz (1985)**<sup>6</sup> argues that efficient markets reduce incentives for individuals to research firms because any new information they uncover is quickly reflected in public stock prices before the individual can exploit the fruits of the research. In other words, investors have the incentive to free-ride on others' efforts to research firms, resulting in inadequate research.

**Allen and Gale (1999)**<sup>7</sup> argue that corporate managers and the boards of directors often collude against other shareholders.

## Views in favour of the market-based economy

Those who stress the comparative advantage of the market-based economy focus on its effectiveness in allocating capital.

**Rajan (2002)**<sup>8</sup> argues that banks can exercise bargaining power over a borrowing firm's profits. This is because of their role as essential financial intermediaries and due to the specific nature of bank lending. Banks often have access to more information about a firm's activities and financial health, giving them a competitive advantage. This information, combined with the firm's dependence on bank financing, can create a power imbalance where the bank can influence the firm's financial decisions and potentially extract a larger share of profits. This may reduce firms' incentives to undertake profitable projects.

**Morck and Nakamura (1999)**<sup>9</sup> banks—as debt issuers—have an inherent bias toward conservative investments, so that bank-based systems discourage innovation and growth.

On the political research front, **La Porta et al. (2002)**<sup>10</sup> argue that state-owned banks are less interested in overcoming market frictions and more interested in achieving political goals. According to this view, state-owned banks are more likely to funnel credit to labour-intensive industries and less likely to identify and fund truly strategic industries. Therefore, proponents of the market-based view stress that markets mitigate the negative repercussions of powerful banks and promote innovative, research and development (R&D)-based industries.

# Insider system vs outsider system

This division is proposed by Julian Franks and Colin Mayer (2001) <sup>11</sup>, referring to the difference in corporate control.

An **outsider system** is characterised by corporate control with **large equity markets, dispersed ownership, and active markets in corporate control**. This refers to a vibrant market where companies and individuals are actively involved in buying, selling, and potentially acquiring ownership and control of other companies. These systems are called outsider systems, given that badly performing managers are disciplined by outsiders, in particular hostile raiders that are on the lookout for firms whose stock price has suffered a major decline. Hence, this market operates through the **threat of takeover**, putting pressure on the managers to act in the interests of their shareholders. The UK and the USA are representatives of the outsider system.

An **inside system** is characterised by a **small number of quoted companies, concentrated share ownership** and comparatively **low levels of takeover activity**. Corporate ownership is characterised by a strikingly high concentration of ownership, primarily in the hands of **families** and **other companies**. Corporate holdings frequently take the form of complex webs of holdings and pyramids of intercorporate holdings. Managers are **monitored by the large shareholder**, frequently the founding family. The large shareholder is typically represented on the board of directors and is also frequently directly involved in the management of the company. Given the concentration of control, the takeover market is fairly underdeveloped and hostile takeovers are virtually unheard of. Hence, these systems are referred to as insider systems, as the monitoring of the management is mainly done by the large shareholder, i.e. one of the company insiders. Continental European countries are representatives of the insider system.

## Legal families

### Investor protection

Rafel La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny have started the law and finance literature by developing a new, path-breaking theory which explains differences in corporate governance and the development of stock markets <sup>12</sup>. Their theory is based on the importance of property rights, in particular **investor protection**. *They argue that in countries where investor protection is high, capital markets will be highly developed as investors are willing to invest in equity and debt securities. Conversely, countries with weak investor protection have underdeveloped capital markets, as investors are concerned about parting with their funds.*

|                                      | High Investor Protection                                                                                                            | Low Investor Protection                                                     |
|--------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------|
| <b>Investor-manager conflict</b>     | Low                                                                                                                                 | High                                                                        |
| <b>Legal action against managers</b> | Strict                                                                                                                              | Loose                                                                       |
| <b>Wealth impact</b>                 | Ensures that a greater portion of the firm's cash flows is distributed to investors in the form of dividends and stock repurchases. | A considerable part of the firm's cash flows may be wasted by the managers. |

|                         | High Investor Protection | Low Investor Protection |
|-------------------------|--------------------------|-------------------------|
| Principle-agent problem | Low                      | High                    |

## Legal system-based division

La Porta et al. distinguish between two main legal families, i.e. **common law** and **civil law**.

|                   | Common Law                                         | Civil Law           |
|-------------------|----------------------------------------------------|---------------------|
| Judgement method  | Case-based.                                        | Code of law.        |
| Adopted countries | UK, USA, and most of the former colonies of the UK | About 150 countries |

In the common law system, judges pronounce judgments based on the cases presented to them, and these judgments create precedents for future, similar cases. Civil law, which originates from Roman law, is based on extensive codes of law such as the Napoleonic code of law. The role of judges is limited to interpreting legal texts in a court of law.

### Note

According to La Porta et al., the fact that common law is case-based makes it more flexible than civil law. While the former can easily adapt to new forms of managerial misuse of shareholder funds, the latter will always lag behind managers' ingenuity as it relies on rewriting and supplementing existing codes of law to adapt to new managerial forms of shareholder abuse.

## Country analysis: law and Investor/creditor protection

In their 1998 study, La Porta et al. measure the protection of shareholders from managerial abuses as well as the protection of creditors for a total of 49 countries. The table below shows the values per country for their measure of investor protection — the anti-director rights index — and their measure of creditor protection.

| Country   | Civic or Common | Anti-director rights index | One-share one-vote rule | Creditor rights index | Debt/GNP | Ownership held by 3 largest shareholders |
|-----------|-----------------|----------------------------|-------------------------|-----------------------|----------|------------------------------------------|
| Australia | 0               | 4                          | 0                       | 1                     | 0.76     | 0.28                                     |
| Canada    | 0               | 5                          | 0                       | 1                     | 0.72     | 0.4                                      |
| Hong Kong | 0               | 5                          | 0                       | 4                     |          | 0.54                                     |
| India     | 0               | 5                          | 0                       | 4                     | 0.29     | 0.4                                      |
| Ireland   | 0               | 4                          | 1                       | 1                     | 0.68     | 0.39                                     |
| Israel    | 0               | 3                          | 0                       | 4                     | 0.66     | 0.51                                     |
| Kenya     | 0               | 3                          | 1                       | 4                     |          |                                          |
| Malaysia  | 0               | 4                          | 0                       | 4                     | 0.84     | 0.54                                     |

| Country             | Civic or Common | Anti-director rights index | One-share one-vote rule | Creditor rights index | Debt/GNP | Ownership held by 3 largest shareholders |
|---------------------|-----------------|----------------------------|-------------------------|-----------------------|----------|------------------------------------------|
| New Zealand         | 0               | 4                          | 0                       | 3                     | 0.9      | 0.48                                     |
| Nigeria             | 0               | 3                          | 0                       | 4                     |          | 0.4                                      |
| Pakistan            | 0               | 5                          | 0                       | 4                     | 0.27     | 0.37                                     |
| Singapore           | 0               | 4                          | 0                       | 4                     | 0.6      | 0.49                                     |
| South Africa        | 0               | 5                          | 0                       | 3                     | 0.93     | 0.52                                     |
| Sri Lanka           | 0               | 3                          | 0                       | 3                     | 0.25     | 0.6                                      |
| Thailand            | 0               | 2                          | 1                       | 3                     | 0.93     | 0.47                                     |
| UK                  | 0               | 5                          | 0                       | 4                     | 1.13     | 0.19                                     |
| US                  | 0               | 5                          | 0                       | 1                     | 0.81     | 0.2                                      |
| Zimbabwe            | 0               | 3                          | 0                       | 4                     |          | 0.55                                     |
| English law average | 4               | 0.17                       | 3.11                    | 36.06                 | 0.43     |                                          |
| Austria             | 1               | 2                          | 0                       | 3                     | 0.79     | 0.58                                     |
| Germany             | 1               | 1                          | 0                       | 3                     | 1.12     | 0.48                                     |
| Japan               | 1               | 4                          | 0                       | 2                     | 1.22     | 0.18                                     |
| South Korea         | 1               | 2                          | 1                       | 3                     | 0.74     | 0.23                                     |
| Switzerland         | 1               | 2                          | 1                       | 1                     |          | 0.41                                     |
| Taiwan              | 1               | 3                          | 0                       | 2                     |          | 0.18                                     |
| German law average  | 2.33            | 0.33                       | 2.33                    | 19.09                 | 0.34     |                                          |
| Argentina           | 1               | 4                          | 1                       | 1                     | 0.19     | 0.53                                     |
| Belgium             | 1               | 0                          | 0                       | 2                     | 0.38     | 0.54                                     |
| Brazil              | 1               | 3                          | 0                       | 1                     | 0.39     | 0.57                                     |
| Chile               | 1               | 5                          | 0                       | 2                     | 0.63     | 0.45                                     |
| Colombia            | 1               | 3                          | 0                       | 0                     | 0.19     | 0.63                                     |
| Ecuador             | 1               | 2                          | 0                       | 4                     |          |                                          |
| Egypt               | 1               | 2                          | 1                       | 4                     |          | 0.62                                     |
| France              | 1               | 3                          | 1                       | 0                     | 0.96     | 0.34                                     |
| Greece              | 1               | 2                          | 0                       | 1                     | 0.23     | 0.67                                     |
| Indonesia           | 1               | 2                          | 0                       | 4                     | 0.42     | 0.58                                     |

| Country                  | Civic or Common | Anti-director rights index | One-share one-vote rule | Creditor rights index | Debt/GNP | Ownership held by 3 largest shareholders |
|--------------------------|-----------------|----------------------------|-------------------------|-----------------------|----------|------------------------------------------|
| Italy                    | 1               | 1                          | 1                       | 2                     | 0.55     | 0.58                                     |
| Jordan                   | 1               | 1                          | 0                       |                       | 0.7      |                                          |
| Mexico                   | 1               | 1                          | 1                       | 0                     | 0.47     | 0.64                                     |
| Netherlands              | 1               | 2                          | 0                       | 2                     | 1.08     | 0.39                                     |
| Peru                     | 1               | 3                          | 0                       | 0                     | 0.27     | 0.56                                     |
| Philippines              | 1               | 3                          | 0                       | 0                     | 0.1      | 0.57                                     |
| Portugal                 | 1               | 3                          | 0                       | 1                     | 0.64     | 0.52                                     |
| Spain                    | 1               | 4                          | 0                       | 2                     | 0.75     | 0.51                                     |
| Turkey                   | 1               | 2                          | 0                       | 2                     | 0.15     | 0.59                                     |
| Uruguay                  | 1               | 2                          | 0                       | 2                     | 0.26     |                                          |
| Venezuela                | 1               | 1                          | 0                       |                       | 0.1      | 0.51                                     |
| French law average       | 2.33            | 0.22                       | 1.63                    | 9.76                  | 0.54     |                                          |
| Denmark                  | 1               | 2                          | 0                       | 3                     | 0.34     | 0.45                                     |
| Finland                  | 1               | 3                          | 1                       | 1                     | 0.75     | 0.37                                     |
| Norway                   | 1               | 4                          | 0                       | 2                     | 0.64     | 0.36                                     |
| Sweden                   | 1               | 3                          | 0                       | 2                     | 0.55     | 0.28                                     |
| Scandinavian law average | 3               | 0.25                       | 2                       | 35.23                 | 0.37     |                                          |

Source: Based on La Porta et al. (1997, 1998); additional material and updates from <https://shleifer.scholars.harvard.edu/publications> (accessed on 30 May 2025)

The **anti-director rights index** ranges from 0 to 6. It increases by 1 for each of the following criteria that are met:

- shareholders can mail their proxy votes
- shareholders are not required to deposit their shares before the AGM
- cumulative voting is allowed
- minority shareholders are protected
- shareholders have a pre-emptive right to buy newly issued shares
- the percentage of shares required to call an extraordinary shareholders meeting is 10% or less.

**One-share one-vote** is set to 1 if the one-share one-vote rule is upheld and 0 otherwise.

The **creditor rights index** ranges from 0 to 4. It increases by 1 for each of the following criteria that are met:

- secured creditors can withdraw their collateral before the completion of the reorganisation
- secured creditors have the right to collateral in the reorganisation
- creditors' approval is needed before managers can file for reorganisation
- managers are replaced by a third party appointed by the creditors or the court while the reorganisation is pending.

**Debt over GNP** is the ratio of the sum of bank debt by the private sector and bonds issued by non-financial firms over GNP for 1994.

**Ownership held by the 3 largest shareholders** is the proportion of common stock ownership held by the 3 largest shareholders in the 10 largest non-financial and non-government-owned companies in 1994.

#### Note

**Shareholder protection and creditor protection are highest in common law countries and lowest in French civil law countries. Countries with German law and Scandinavian law are somewhere in between.**

## Left-wing vs right-wing

Mark Roe argues that politics and political ideology as the main drivers behind corporate governance <sup>13</sup>. Differences in political ideology may explain the marked differences between the corporate governance systems of Continental Europe and the USA.

The **Continental European** social democracies have achieved social peace by **favouring employees over investors**. **Layoffs** will be relatively **hard**, even though they may increase efficiency; **unemployment benefits** will be high, as will be unemployment rates. Managers are less likely to focus exclusively on the maximisation of shareholder value. There will be less takeover activity as takeovers may generate layoffs.

In summary, social democracies will seek social equality at the cost of economic efficiency. As a result of the focus of social democracies on employees rather than investors, control and ownership will remain concentrated, as this is the only way to keep managers and employees at bay.

In contrast, in **countries with more conservative governments**, the focus will be on **improving the rights of investors** rather than those of workers. Given the strong legal protection of investor rights, **ownership and control will be separate** and large corporations will be characterised by **diffuse ownership and control**.

#### Important

The underlying assumption of Mark Roe's argument:

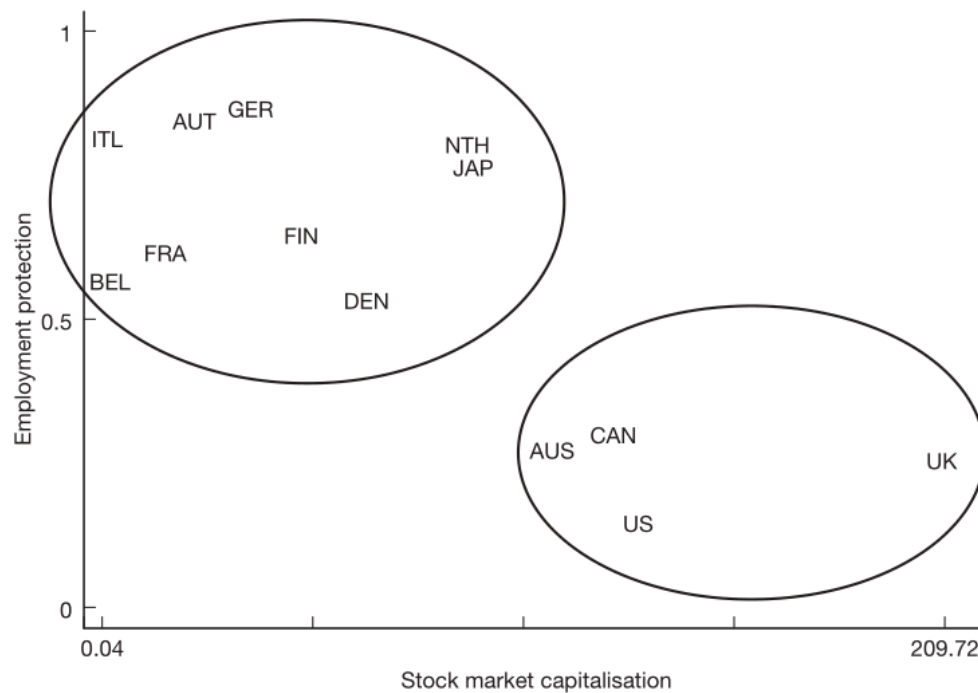
**Strong investor rights cannot coexist with strong employment protection.**

Roe argues that the focus of social democracies on employee welfare rather than on shareholder value maximisation explains why ownership and control in Continental Europe are so concentrated: shareholders need to be strong to face managers and employees with strong legal rights and to mitigate agency problems.

# Liberal market economy vs coordinated market economy

Hall and Soskice (2011) <sup>14</sup> argue that economic systems are not just about investments in assets and technologies, but also about investments in human capital, such as the development of workers' skills and competencies. The way economic coordination problems are resolved depends on whether an economy is a **liberal market economy** (LME) or a **coordinated market economy** (CME)

|                        | <b>Liberal Market Economy (LME)</b>                                                                                                                                                                                                                                      | <b>Coordinated Market Economy (CME)</b>                                                                                                                                                                                                                                                                                                                                                                                                     |
|------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Coordination mechanism | The Markets                                                                                                                                                                                                                                                              | Complex networks to coordinate economic decision-making                                                                                                                                                                                                                                                                                                                                                                                     |
| Liquidity              | Labour markets and asset markets are both highly flexible and well-developed.                                                                                                                                                                                            | Markets such as the labour market and the capital market are fairly illiquid and inflexible.                                                                                                                                                                                                                                                                                                                                                |
| Market focus           | Given the emphasis on markets, firms tend to invest in highly marketable and liquid assets that can easily be sold or transferred should the need arise. There is an emphasis on assets that have relatively short payback periods and generate fairly quick cash flows. | There is less focus on highly liquid and generic assets, and the emphasis tends to be on more specific, less marketable assets.                                                                                                                                                                                                                                                                                                             |
| Employee treatment     | Firms tend to keep the training of their employees to a minimum, as there is a danger that competitors may free-ride on a particular firm's training efforts by poaching its employees once they have been fully trained.                                                | Firms provide in-house, industry-specific training for their workers and powerful employers associations police firms to ensure that no firm free-rides on their competitors' training efforts by poaching their employees. High employee protection and inflexible labour markets provide workers with the right incentives to invest over the long term in their human capital by acquiring highly firm-specific skills and competencies. |
| Innovation             | LMEs tend to excel in highly competitive, innovative industries as well as low-value-added service industries.                                                                                                                                                           | CMEs tend to do relatively well in industries associated with incremental innovation, such as high-value-added manufacturing.                                                                                                                                                                                                                                                                                                               |
| Examples               | The UK, the USA and Australia are examples of LMEs.                                                                                                                                                                                                                      | Examples of CMEs are France, Germany and Italy.                                                                                                                                                                                                                                                                                                                                                                                             |



source: Hall and Soskice (2011)

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