

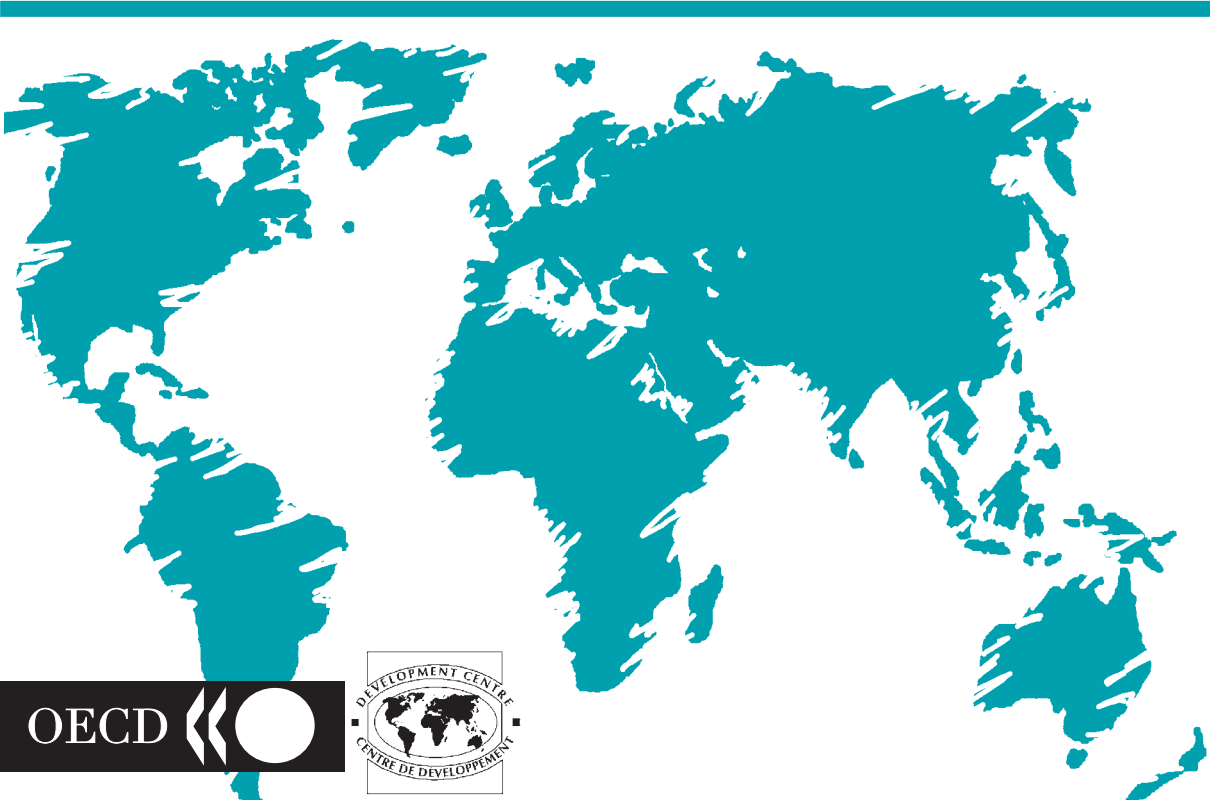


Development Centre Studies

Governance Culture and Development

**A DIFFERENT PERSPECTIVE
ON CORPORATE GOVERNANCE**

By Nicolas Meisel



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FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

This book was written in the context of the Development Centre's work on Finance for Development, including work on the OECD's strategic objective of Enhancing Public and Private Sector Governance.

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Preface

Corporate governance continues widely, yet mistakenly, to be perceived as being of little importance for developing countries. A major cause of this misperception is the widespread belief that the institutions of corporate governance serve mainly to protect the interests of shareholders from the potential misbehaviour of managers in large companies in which management is separate from ownership and whose shares are widely traded on stock markets.

Such large privately owned companies are scarce in developing and emerging market economies. Instead, companies are often directly controlled by a single or small number of powerful shareholders closely linked to managers, while stock markets remain generally shallow and illiquid. This contrasted picture goes far to explain why corporate governance is widely thought to be of little importance in developing and emerging market economies.

Recent OECD Development Centre research on the importance of corporate governance for developing countries and the OECD Regional Corporate Governance Roundtables should help to dispel this misperception. The available evidence suggests that the quality of local corporate governance can greatly affect the ability of a developing or emerging market economy to achieve sustained growth. Yet it also raises a challenging question: How can one explain the experiences of countries, notably in Continental Europe during the post-war period and in Asia from the 1960s to the 1990s, which have achieved high levels of growth over long periods of time while seemingly characterised by poor-quality corporate governance?

This study was undertaken to address that question. In doing so it highlights the close and crucial relationship between a country's institutions of corporate governance and its institutions of *public* governance. It coins the

concept of “governance culture”, which appears to be a useful tool for understanding the ability of a country’s governance institutions to build and share trust, power and information throughout society.

The study’s focus on France reflects the potential value for decision and policy makers in developing and emerging market economies of understanding both how France’s institutions of governance made possible the country’s remarkable post-war experience of “catching-up” growth, and the major governance challenges it has faced in shifting to more innovation-based growth since the 1970s. Whether they are trying to achieve and sustain a process of catching-up growth, or are facing the challenge of making a transition from catching-up to more innovation-based growth, most developing and emerging market economies today face, or will soon face, strikingly similar challenges. This study is rich in insights for them, and will constitute a highly valuable compass.

Louka T. Katseli
Director
OECD Development Centre
April 2004

Summary

The criteria used to evaluate the institutions of corporate governance in developing countries tend heavily to be drawn from studies of the experiences of the United States and the United Kingdom. By these criteria, the quality of the institutions of corporate governance in East and Southeast Asia during the “Asian Miracle” from the 1960s to the 1990s could only be judged as poor. The quality of corporate governance in France during the *Trente Glorieuses* (1945-1973), when the country experienced the highest sustained growth in its history, would similarly have to be judged poor.

Students of the role of corporate governance in a country’s long-term development process thus face a dilemma. Either the quality of a country’s corporate-governance institutions is not likely to play a significant role in the country’s long-term growth process, or the criteria generally used to evaluate such institutions need to be reviewed. This study draws on France’s experience to question the criteria and give new perspective to corporate-governance challenges in today’s developing and emerging market countries.

The intertwined trajectories of corporate governance and economic development are examined since the emergence of corporate capitalism in France at the end of the 19th century. Dominated by the oligopolistic interaction of vested interests during the Third Republic (1870-1940), France’s *governance culture* changed with the Second World War when the state came to impose itself as the uncontested focal point in national governance relationships. It established a monopolistic public focal point of governance that effectively co-ordinated economic actors’ interests and expectations. Beginning in the 1970s, however, changes in the national, regional and international contexts weakened the effectiveness of this system. Destabilised by a complexity of uncertainties and new actors, France’s corporate-governance institutions were obliged to change. This transformation did not take place without strong opposition, particularly from those elites attached to the reigning governance culture that had conferred their status upon them.

Drawing on the experience of France and several developing countries, the study proposes a systematic analysis of the institutional mechanisms of trust-, power- and information-production and sharing. It thus elaborates a new interpretative framework for analysing corporate-governance and institutional-reform options open to developing countries and emerging economies.

This framework points to the importance of not seeing corporate-governance institutions in isolation from the governance culture in which they are embedded. It also sheds new light on governance cultures: their logic, their dynamics of change and the “traps” (low-level equilibria in economists’ jargon) in which they may get stuck. Finally, it clarifies a major challenge for governance institutions in all countries engaged in a process of catching-up development: to ensure the quality of their transition from “extensive” development strategies based on the mobilisation of factors of production (human, physical and financial), towards more “intensive” strategies based on innovation.

Chapter I

Corporate Governance and National Development

Summary

The criteria widely used to assess the quality of a country's institutions of corporate governance largely reflect the historical experiences of the United States and the United Kingdom. This chapter asks whether these criteria can appropriately be used to assess the quality of such institutions in countries, including France in the post-war period and many developing and emerging-market economies today, whose systems of governance, which have much in common with each other, differ significantly from those of the United States and the United Kingdom.

Introduction

Vivendi, Ahold, Parmalat, Enron, WorldCom, Arthur Andersen: these are but a few recent examples of poorly governed corporations. They remind us of the extent to which the quality of corporate governance can affect not only a nation's economic growth but the lives of millions of individuals – investors, savers, employees, retirees, suppliers, consumers – in even the most developed countries.

What about corporate governance in developing countries? Do the institutions of corporate governance play any significant role in a country's longer-term development process?

While the *OECD Principles of Corporate Governance*¹ have drawn decision makers' attention worldwide to the importance of these institutions, recent Development Centre work flags the extent to which the interaction between

corporate governance and economic development deserves particular attention in countries where development is the principal challenge². This work shows that reasonably sound corporate-governance institutions are essential to transform national systems of governance based largely on informal relations between private interests (relationship-based systems), which prevail in many developing countries, into systems based on more transparent mechanisms and greater respect for the rule of law (rules-based systems). The move from predominantly relationship-based to rules-based systems is crucial for long-term national development.

Can one conclude, then, that in the absence of reasonably sound local corporate-governance institutions, a country's long-term economic development process will be either slowed or stopped?

There is no easy answer to this question. For example, if the quality of corporate-governance institutions plays an important role in economic development, how can the phenomenal growth of the East and Southeast Asian economies during the period from the 1960s to the late 1990s be explained, given the prevalence in those economies during that period of what many would now identify as very poor corporate governance? Equally paradoxical is the case of France during the period from 1945 to 1973, when, despite having corporate-governance institutions clearly contrary to today's standards of good governance, the country experienced a major period of strong and sustained, even accelerating, economic growth (significantly called the *Trente Glorieuses* – the “Glorious Thirty”).

Arguably, if one accepts that a sustained rise in *productivity* is a key element of long-term economic development³, then perhaps the “Asian Miracle” is not entirely paradoxical with respect to the role of corporate governance. As several authors have asserted⁴, the remarkable period of high and sustained Asian output growth from the 1960s to the late 1990s may have derived more from a massive mobilisation of factors of production in the region than from productivity growth per se. To the extent these authors are right, the “Asian paradox” could be resolved by the possibility that such a mobilisation of factors is significantly less incompatible with poor local institutions of corporate governance than is sustained productivity growth.

It is in this latter respect – the relationship between corporate governance and sustained productivity growth – that the French case is particularly interesting. Whether or not one accepts to differentiate “extensive” national growth (based heavily on factor mobilisation) from “intensive” growth (based more on productivity growth) in order to resolve the Asian corporate-governance “paradox”, the French “paradox” remains intact. Econometric

analyses (Carré *et al.*, 1972) show that growth in France during the *Trente Glorieuses* was based heavily on productivity growth. Yet throughout this period France's system of corporate governance remained distant from what are now commonly accepted standards of "sound" governance⁵.

Moreover, to those investigating the role of corporate governance in national development processes, France's experience appears considerably more relevant than those of the United States and the United Kingdom, even though the latter provide the principal sources of reference in the field. The greater apparent relevance of France's experience is due to the fact that until recently French corporate-governance institutions much more closely resembled those of developing countries. Notable similarities between France, until recently, and many developing and emerging-market countries include:

- a high degree of *concentration* both in corporate ownership structures and (even more concentration) in effective corporate control structures;
- the absence of effective *checks and balances* either internal or external to corporations;
- a great permeability between local institutions of corporate governance and those of *political* governance;
- a *judiciary* whose independence often leaves much to be desired, notably in commercial and business law;
- strong executive powers that are economically interventionist and poorly or barely controlled by national parliaments;
- financial systems long organised around the *state* or around *banks controlled by it*, leading to poorly developed stock markets and/or a lack of liquidity in financial markets;
- the importance of *clan-like and family relations* in the organisation of corporate governance structures;
- the predominance of *informal inter-personal relationships* in the regulation of interactions between private interests.

These characteristics stand in opposition to what in principle constitutes the basis of healthy corporate-governance institutions⁶. Ignoring these characteristics, much of the literature on corporate governance starts from the separation between ownership and management, which effectively characterises many large American companies (Berle and Means, 1932), as the *raison d'être* of corporate governance. Indeed, in the first decades of the 20th century, management of many large US corporations was abandoned by

the founders' heirs in favour of professional managers who progressively gained the upper hand over stockholders in controlling the process of resource allocation in corporate America (Roe, 1994). Faced with widely dispersed shareholders, most of whom never exercised their voting rights, managers of large companies increasingly found themselves freed *de facto* from shareholders' control.

Following the difficulties encountered by a few US conglomerates in the 1970s, renewed attention was given to the divergence of interests between "principals" (corporate owners, i.e. shareholders) and their "agents" (managers). Studies pointed out that if managers were responsible for maximising corporate profits, they were often likely to maximise their own, even to the detriment of those of shareholders. Being the only investors in the company whose interests were not contractually protected, shareholders risked seeing their "residual" profit eroded by management negligence or self-dealing⁷. From this observation a precise definition of corporate governance emerged: "Corporate governance deals with the way in which suppliers of finance to corporations assure themselves of getting a return on their investment. [...] How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do they control managers?" (Jensen and Meckling, 1976).

The success of this approach was reinforced by the consequences of the "conservative revolution" (diffusing from the United States and the United Kingdom following the failure of Keynesian recipes to solve the "stagflation" problem of the 1970s): with the rise in interest rates, cheap credit was over, and financial markets started to be the new locus of economic evaluation. Demographic trends in western societies added to this phenomenon with a dramatic growth in the level of savings channelled through different types of institutional investors searching for profitable investments. Among them, a few American public pension funds started loudly to require "good" corporate governance practices in the mid-1980s, with a particular emphasis on the functioning of proxy voting procedures and the removal of anti-takeover devices. This claim then spread among other financial actors, in particular mutual funds whose "corporate governance demands" were generally linked to much shorter-term concerns (such as being able rapidly to extract shareholder value). Henceforth, if a company sought to reduce the risk premium demanded by shareholders, it had to offer them guarantees in the form of a panoply of control mechanisms (special committees within the board of directors, audits, independent administrators, an external control market making the threat of takeover real, etc.) and incentives (stock options, bonuses, etc.) tailored to "align" the interests of managers and shareholders.

Notwithstanding its influence in academic circles, this analysis of corporate governance is clearly marked by the Anglo-American institutional setting from which it emerged. That setting is characterised by:

- capital ownership that is largely dispersed in the hands of relatively passive shareholders, on highly liquid capital markets;
- a clear distinction between shareholders and managers;
- a private sector (composed of financial institutions, companies, investors and stock markets) that is autonomous from the state with regard to corporate financing;
- an independent judiciary capable of guaranteeing respect for private contracts and property rights.

This setting corresponds very poorly with the institutions of corporate governance found in the overwhelming majority of developing, emerging-market and transition economies⁸. Yet Anglo-Saxon practices remain by far the most studied and referenced in the field, to the point that many academic corporate-governance studies simply take for granted that certain institutions exist and function properly (particularly those related to external control). In so doing, they underestimate the importance of those institutions. The result is two-fold: first, corporate-governance practices in developing countries are only partly, and thus poorly, understood within a predominantly financial rationale that is almost exclusively focused on shareholder-manager relations; and second, changes in these practices only marginally adhere to the prescribed recommendations, as these implicitly presuppose all or part of an institutional setting that was the product (elsewhere) of a long process of institutional construction and cultural diffusion that these studies largely ignore⁹.

Analysis of the French “paradox” illustrates precisely that in order to evaluate the impact of corporate-governance institutions on national development, it is necessary to take into account the *dynamics of institutional construction* and the national *governance culture* that together shape actors’ representations and determine organisational structures in a country.

What is the meaning of “governance culture”? A number of recent works insist on the possibility, even the necessity, of enriching our understanding of systems of corporate governance by integrating such non-economic dimensions as legal, political, historical and cultural factors¹⁰. The intrinsic relationship of corporate-governance institutions with a range of other institutions (notably institutions of political governance) in structuring the development process

appears to have empirical roots. The notion of governance culture is used in this study to give recognition to these multiple influences which, in any country, are translated into the institutionalisation of a national *system* of corporate governance.

Following Oman (2003), corporate governance can thus be defined as the entirety of “private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs (‘corporate insiders’) on the one hand, and those who invest resources in corporations on the other. Investors can include suppliers of equity finance (shareholders), suppliers of debt finance (creditors), suppliers of relatively firm-specific human capital (employees) and suppliers of other tangible and intangible assets that corporations may use to operate and grow.”

Of course, given this definition, there would be little point in recommending the adoption by a developing country of “good” practices or institutions of governance drawn directly from an advanced economy, such as France, which was engaged in a major *reconstruction* effort at the outset of the *Trente Glorieuses*. The initial and local conditions that shape national trajectories differ so much that they make the “French model” difficult to transpose. Moreover, the fact that France has moved away from this model since the 1970s makes the notion of transposing it even less directly applicable.

This study aims to clarify the choices decision makers in developing countries face by attempting to demystify the way in which the corporate-governance institutions of a now developed country were actually constructed and what role they played in its development process¹¹. This work does not pretend that they were *the* key to success but certainly *one* of the keys, which is enough to bring us to see the whole debate over “bad or good” corporate governance — and eventually governance as a whole — in a new light. The case of France illustrates how a unique, even unconventional, path towards developing a governance culture can ensure the quality of the process of societal transformation. It thus obliges us to question our usual frame of reference and to seek a better-suited one for developing countries.

The remainder of this study comprises four chapters. The first three examine corporate governance in France during each of three broad historical periods: the Third Republic (1870-1940); the Second World War and the *Trente Glorieuses* (1940-1973); since the 1970s. The final chapter models governance cultures with a view to drawing parallels between France’s experience and that of some developing and emerging market countries, to highlight implications for the developing world today.

Notes

1. The *OECD Principles of Corporate Governance* (OECD, 1999), currently in revision (see OECD, 2003a), are accessible on www.oecd.org. The five primary Principles call for: protecting the rights of shareholders; ensuring equal treatment of all shareholders, including foreign and minority shareholders; recognising the rights of various “stakeholders” in the life of the company and encouraging their participation; guaranteeing transparency and the diffusion of all information pertinent to the company; and ensuring that the board of directors fulfils its responsibilities vis-à-vis the company, its shareholders and the various stakeholders.
2. See, in particular, Oman (2003), Oman *et al.* (2003), Thillainathan *et al.* (2004) and Lin (2001). See also OECD (2003b).
3. See, for example, Oman *et al.* (2003) and Braga de Macedo *et al.* (2002), chapter 12.
4. See Krugman (1994) in particular. See also Oman *et al.* (2003).
5. Two benchmarks in terms of what are now commonly accepted standards of “sound” corporate governance are the Cadbury Report (1992) and the *OECD Principles* (1999).
6. La Porta *et al.* (1997, 2000) point to the importance of legal traditions as a principal determinant of national institutions. Many developing countries are considered to have civil law traditions of French origin (the Napoleonic Code, or the Civil Code, dates from 1804). By offering less legal protection than systems regulated by common law (of Anglo-Saxon origin), civil-law systems are thought to encourage investors to acquire blocks of control rather than to remain minority shareholders in order to exert real influence over managers. See, however, Rajan and Zingales (2001) and Woo-Cumings (2001), among others, for critical views on this thesis.
7. See Jensen and Meckling (1976); Fama (1980); Fama and Jensen (1983a, 1983b).
8. See, for example, CIPE (2002), OECD (2003b), and Oman (2003).
9. See also Frémond and Capaul (2002).

10. See La Porta *et al.* (1997), Licht (2001), Oman (2003), Roe (2002) and Stout (2003).
11. More generally, improving our understanding of the diversity of developed countries' experiences, while sidestepping development myths, could well avoid waste in developing countries. The costly experiences of abandoned privatisation or stock-market-development plans in certain transition countries (Bulgaria, Lithuania, Macedonia) or developing countries (Tanzania) are cases in point. See also Chang (2002): "We can, and should, draw lessons from the historical, as opposed to the current, state of developed countries in the area of institutional development. In this way, developing countries can learn from the experiences of developed countries without having to pay all the costs involved in developing new institutions (one of the few advantages of being a 'latecomer'). This is significant because, once established, institutions may be more difficult to change than policies."

Chapter II

Corporate Governance and the Interplay of Private Interests: Institutional Legacy on the Eve of the French Miracle

Summary

The corporate-governance institutions of the *Trente Glorieuses* (1945-1973) in France were constructed by drawing lessons from the institutional failures of the Third Republic (1870-1940). This chapter therefore focuses on the Third Republic. How and why did institutions during that period fail in their mission, given that the country otherwise benefited from high levels of human, social and technical development? The answer is two-fold:

- 1) They failed to allow substantial investment resources to be freed and channelled to companies when self-financing reached its limits. Neither banking nor capital markets, nor public finance, took up the financing mantle as vigorously as they did in other rapidly growing advanced economies, notably Germany and the United States, during this period. Companies in France developed partial substitutes by resorting to inter-company cross financing, encouraging the birth of corporate-governance structures typical of an insider system. These methods, adhering to a logic similar to that found in the majority of developing countries today, enabled companies' governing bodies to be sheltered from all external and independent control.
- 2) The political and judicial governance institutions failed to facilitate companies' financing or to impose a regulatory framework that could have rendered their governing bodies accountable and prevented the spread of anticompetitive practices.

The result at the end of the period was an oligopolistic concentration of power in both capital and product markets that were subject to the machinations of the most powerful vested-interest groups. The manipulation of corporate-governance institutions for private ends was accompanied by an incapacity of public-governance institutions to induce the interplay of private interests to favour realisation of the broader public interest. This double evolution strongly contributed to hindering national development, delaying fulfilment of the country's growth potential until after the shock of the Second World War.

Introduction

French institutions of the *Trente Glorieuses* (1945-1973) were largely constructed in reaction to the trauma provoked by 15 years of uninterrupted crisis that included the economic crisis of the 1930s and the economic, political and moral crisis of the war years, with an authoritarian regime (Vichy, supported by the majority of the economic elite) that collaborated with the occupier and left the country humiliated, pillaged and starving in 1945 – not to mention the devastation caused by war. Thus, understanding the institutions (political, economic, and more precisely those playing a role in corporate governance) that made the “French miracle” of the *Trente Glorieuses* possible requires an evaluation of the historical context in which they were born, as well as the (sometimes contradictory) contributions made to them by their predecessors.

France’s first Industrial Revolution took place close on the heels of the United Kingdom’s at the beginning of the 19th century. By the beginning of the 20th century, all of the technical capabilities characteristic of the Second Industrial Revolution were in place: steel, electricity, petrol, railways, telegraph, industrial chemistry, automobiles, aeronautics, etc. These sectors innovated at a sustained rhythm between 1900 and 1930 with average growth of 5 per cent per annum, which was triple that of the rest of the economy (Lévy-Leboyer, 1991).

In other advanced industrialised countries, this technological change came with an organisational change: the emergence of “corporate capitalism”, marked by the rise to predominance of large companies substituting a huge system of internal co-ordination of the means of production and commercialisation (Chandler’s “visible hand”) for market co-ordination (Smith’s “invisible hand”) (Chandler, 1990). Yet corporate capitalism in France did not experience a boom comparable to that of other big industrialised countries (notably the United States, Germany and the United Kingdom) which surpassed France in terms of economic growth (Table II.1). Whereas the development of big business marked these other countries between 1870 and 1940 (Schmitz, 1993), in the middle of the 20th century France still retained the characteristics of “small” capitalism – fragmented, weakly competitive and suffering from poor framework conditions provided by the state. In 1945, France’s pre-war finance and corporate-governance institutions were seen as incapable of rising to the challenge of modernisation, and also as largely responsible for the debacle of the previous 15 years and for France’s “lag”. What are these institutions? To what extent, and why, did they fail in their mission?

Table II.1. **Production Growth 1820-1950**

	GDP (billions of \$ 1990)				Average annual growth (%)
	1820	1870	1913	1950	1820-1950
United States	12	98	517	1 456	3.8
United Kingdom	36	100	225	348	1.8
Germany	26	71	237	265	1.8
France	38	72	144	220	1.4
Italy	23	42	95	165	1.5
Japan	21	25	72	161	1.6

Source: Maddison (2001).

Corporate Governance and Corporate Finance Institutions

What is the spectrum of institutions relevant to corporate governance? Following the definition given in Chapter I, it is important to highlight the impact of:

- the legal framework;
- boards and managers as main actors of internal governance;
- workers as suppliers of human capital;
- banks and securities markets (bonds and shares) as suppliers of finance capital;
- public authorities as regulators of the overall business environment.

Large Corporations in the Civil Law Framework: From Public to Private Domain

Prior to the Napoleonic Codes of the beginning of the 19th century, joint-stock companies were part of the state's domain. In the 18th century, the king alone had the power to create entities endowed with a legal personality (*personnalité morale*). Sovereign royal will framed the operations of all commercial companies, guilds and other such "intermediary" bodies. "By the concession system (*Verleihung* in German law) public authorities ratified a given professional activity and delegated it to a large corporation that, by this delegation of power, benefited from a part of state sovereignty." (Ducouloux-Favard, 1992)

The liberal legal traditions that inspired the great founding texts (notably the American Constitution of 1787 and the Declaration of the Rights of Man and the Citizen in France in 1789) emanated from essentially agricultural societies that were concerned with freeing the individual from the yoke of various intermediary bodies. They therefore only recognised two legal entities: individuals and the state. No intermediary interest could come between the interests of individuals and the general interest without risking interference with society's mechanism of self regulation (through the interplay of market forces and the democratic state). At the end of the 18th and beginning of the 19th centuries, this liberal hostility towards intermediary bodies targeted the *Ancien Régime's* monopoly "corporations"¹ and joint-stock companies alike. In 1791, at the height of the revolutionary period, the *Le Chapelier* law officially dissolved and outlawed them all. Without limited-liability joint-stock companies, however, no large business enterprises could exist.

In 1805, the Civil Code established private property as an inviolable right, thus giving legal force to private-law contracts and ensuring that they would be enforced by public authorities. In 1807, the Commercial Code (*Code du Commerce*) recognised the existence of companies with commercial ends (*sociétés à vocation commerciale*), and identified three types: general partnerships, limited partnerships² and limited-liability corporations.

In the last of these, investors were liable only to the extent of their investment. The principle of limited liability was thus laid down (Article 33). In French, the joint-stock limited company was referred to as "anonymous" (*société anonyme*) because non-managing investors were not registered. Nevertheless, in view of the amount of capital that could be involved, and the risk it could entail for small investors and public order, the creation of such companies remained a sovereign affair, requiring special state authorisation (Article 37). Such authorisation was both slow — taking on average two years to complete — and costly.

In 1825, the state further ruled that to qualify for the status of *société anonyme* a company must *pursue a public purpose*. This requirement opened the way for the state to appoint a "censor" who would monitor the company's operations. Permission to form *sociétés anonymes* was also only granted in exchange for guarantees regarding the partners' reliability, and only when no other corporate form was possible. In sum, "the state (*Conseil d'État*) regarded the *société anonyme* as a substitute for issuing state loans [and not as] a legal instrument belonging to the private sphere" (Robé, 2000)³. In all, only 651 such companies were authorised to form between 1807 and 1867.

Only when faced in the 1860s with the capital requirements of new technologies (particularly railways) and the need for banks to strengthen their growing balance sheets combined with the effects of competition from English companies (authorised by the 1862 Free Trade Treaty to operate on French soil) would government authorisation finally be abolished in 1867 after a first partial liberalisation in 1864⁴. Henceforth, the business corporation was no longer a sovereign affair (whether of the king or of the people as a whole). It had become a private matter, one of private agreements between individuals.

Boards and Managers: From the College to the Separation of Powers

In 1867, the first major law governing limited-liability joint-stock companies organised a “collegiate” of power: joint-stock companies had to be administered by one or several appointed individuals who could choose a director among themselves (Article 22); directors had to own a number of shares laid out by the statutes (Article 26); and directors were liable for legal infractions and management errors (Article 44).

It is striking that this law did not comment on the role of the chairman of the board of directors. In practice, how was power balanced in the organisation? Directors (agents) made major decisions in council. They elected a chairman from their midst whose role was to organise and preside over meetings. Control of the business was delegated either to a director (chosen among them but distinct from the chairman) or to a general manager (outside agent) (Peyrelevade, 1999). While the college of power was established in law, its duality was thus established in practice. Although this solution corresponded in principle to an effective arrangement in terms of checks and balances, it would come in the 1930s to be accused of diluting responsibilities.

Workers Played a Negligible Role in Corporate Governance

Workers’ collective-action capacities steadily improved during the period: “professional associations”, and thus unions, were legally authorised in 1884. The first big union (the CGT) was born in 1895, the second (the CFTC) in 1919. The first elements of a legal framework for collective wage-bargaining appeared during the First World War, but the crisis of the 1930s caused such practice to decline rapidly. The necessity of taking into account the purchasing power of workers in salary negotiations was officially acknowledged in the 1920s (at times of high inflation) and led nominal salaries to follow the level of prices (Bénassy *et al.*, 1979). In spite of these improvements for workers, and the social reforms

introduced by the Popular Front government at the end of the period (1936-1938) which gave workers the right to elect their delegates for collective bargaining and organised sector-wide collective bargaining (*conventions collectives*), workers were still far from being able to influence corporate governance.

Limited Role of Bank Finance

Several factors could have led to an expansion of bank-led sources of corporate finance: the 1867 law and its liberalisation of the rules governing the creation of limited-liability companies, the birth in the same period of large deposit banks (*Crédit Industriel Commercial* in 1859, *Crédit Lyonnais* in 1863, *Société Générale* in 1864), and the unification of the national money market under the direction of the *Banque de France*. However, the bankruptcy of the *Crédit Mobilier* in 1871 and other banks involved in industry gave a huge audience in France to the arguments of the founder of the *Crédit Lyonnais*. He advocated that deposit banks withdraw from industry entirely, arguing that these investments were far too illiquid and risky given the banks' obligations to depositors.

France's large national banks, while opening up offices all around the country, therefore specialised in local retail banking (*banques de proximité*) and set tight limits to their industrial risk-taking. They primarily:

- granted short-term loans to businesses (discount operations);
- ensured public or quasi-public (e.g. railway) bond issuances, both domestic and especially foreign (Table II.2);
- offered financial-engineering services (equity operations, international-trade finance).

Table II.2. Gross Financial Market Issues (% of Total Issues)

	1896	1900	1913	1924	1930	1938	1949	1959
State ^a	2.5	1.8	5.4	38.7	6.2	81.2	62.5	13.9
Companies ^b								
Equity	22.5	36.4	28.3	44.0	35.4	15.6	25.0	47.2
Bonds	27.5	32.7	31.5	16.0	45.8	3.1	12.5	38.9
Foreign	47.5	29.1	34.8	1.3	12.5	-	-	-
Total (% of GDP)	4.0	5.5	9.2	7.5	9.6	3.2	24	3.6

Note: a) Central government, local administration and public lending bodies.

b) Private and public companies.

Source: from Carré *et al.* (1972).

French banks thus developed considerable technical expertise, but without directly participating in governing corporations. This behaviour stands in contrast to their German counterparts, which were involved as long-term capital investors in German industry⁵. Teneul (1960) estimates that long-term credit reached 1 per cent of corporate financing at its peak in France in 1929; Lévy-Leboyer and Bourguignon (1985) confirm a very weak overall level of bank lending in the financing of corporate investment in France.

Late and Short-Lived Recourse to the Stock Market

French stock-market culture was deeply marked by an early financial bubble, which started soon after the establishment of the Third Republic in 1870. First concerning railways (many of which were bailed out by the state in 1878, thus creating moral hazard) and then the whole financial sector, the first huge speculative bubble of French stock markets burst in 1882. It had lasting implications for corporate finance since banks decided to withdraw from long-term investment for good, while the private securities market long remained associated, in the minds of industrial managers and small investors, with potential fraud and speculation (Hautcoeur, 1997). This distrust was reinforced by the 1889 bankruptcy of the Panama Company and the huge subsequent political and financial scandal (set up in 1880 to build a canal, the company had successfully launched massive and popular bond and share subscriptions). Generally speaking, until the First World War, very few private industrial firms financed their investments through the stock market, a market which remained dominated by foreign and domestic bond issues, public and semi-public (e.g. railways and public utilities), and associated in people's minds — sometimes at their expense — with state guarantees. From the 1890s to 1914, low inflation and increasing liquidity strengthened these types of securities on the stock market. Although an equity-investment culture developed in France, it was thus fundamentally risk-averse.

It was not until the 1910s, and particularly until the 1920s, that the *private* securities market seriously started becoming important. It supplied 39 per cent of total corporate financing (23 per cent from shares, 16 per cent from bonds) on average between 1913 and 1928, when a parallel rise in living standards and in public and private financing needs led to a rise in security issues. These issues first peaked in 1913 (Table II.2), and after grinding to a halt during the war years (1914-1918) restarted at a brisk pace, as in other industrialised countries, with total issues reaching a value equivalent to 22.6 per cent of GDP in 1920 (more than twice the pre-war figure). Yet the financial

landscape was deeply affected by the war years: foreign issues in France stopped, the state's short-term debt ballooned to 85 per cent of GDP in 1919, and inflation was high.

Inflation grew worse until the second half of the 1920s and tended to divert savings from the public and private bond market. Rising prices encouraged both small investors to venture into the market and companies to finance new investments with securities issues. The major part of savings went to the share market, which experienced an impressive growth until the end of the decade, also largely promoted by financial intermediaries' search for profits (Hautcoeur, 1996).

Yet the causes of this expansion soon disappeared. First, by devaluing the currency in 1928, Poincaré's government managed to stabilise the Franc and restore confidence in the state's ability to repay its debt and control inflation. Investors then started to turn again to bonds. Between 1927 and 1932, funds raised on the securities market still accounted for 75 per cent of corporate investment financing (Lévy-Leboyer, 1991). Yet the price of shares started to decline as early as February 1929, reflecting a rising prudence towards shares even before the crisis arrived. This shift was also partly due to the obvious entrenchment strategies of private-sector managers, who made extensive use of shares with multiple votes (multiple-class shares) and shareholding networks, and aroused distrust among the public, especially among small investors (Hautcoeur, 1996, 1998, 1999).

If economic agents were well warned of the risks of inflation, they experienced the joys of shareholding without really being aware of the risks associated with venturing into the stock market. The shock of the American crash in 1929 not only ruptured the stock market's unprecedented momentum in France. Together with several huge scandals (Hanau in 1928, Pacquement in 1929, Oustric in 1930, Aeropostale in 1931, Stavisky in 1934) and bankruptcies in the 1930s (including 670 banks between 1929 and 1937), it had profound and sustained negative repercussions on French attitudes both towards large corporations and corporate bosses and towards investing in the stock market.

Companies Adapt their Financial Management

A number of factors mitigated the effect of restricted sources of external corporate financing, at least until the start of the 20th century. First, the bulk of financing needs was met by reinvested profits (often high as a result of low salary levels and high innovation rents). Self-financing is estimated to constitute

about 80 per cent of listed companies' sources of finance at the beginning of the century (Hautcoeur, 1998) and probably even more both for non-listed companies and earlier in the 19th century. Second, entrepreneurs in need of funds often raised them from within their families and/or via marriage alliances, solutions which offered them the advantages of retaining control of the company and of preserving family wealth intact and independent from external capital. Indeed, issuing shares had the shortcoming of diluting control, while borrowing from banks presented the risk of having to admit one or more bank representatives to the board of directors and added to fixed costs, thus reducing future financial flexibility.

Yet, from the beginning of the 20th century and especially after the First World War, self-financing was increasingly less able to keep up with the rhythm of investments. The development of new customer services (maintenance, repairs, credit, etc.), the internalisation of marketing operations formerly carried out by trading companies, the diversification by traditional firms into technologically new manufacturing industries (aluminium, synthetic fibres, etc.) and the increasing complexity of products (lengthening production cycles) all strongly contributed to the increasing need for capital among industrial firms. Furthermore, banks had stopped lending short-term after the war as they were already heavily burdened with public short-term debt in a context of rising inflation (Hautcoeur, 1996).

This accumulation of constraints led firms to search for new sources of funds. In the atmosphere of the 1920s, having recourse to the stock market was of course a possible solution, even if it was not necessarily the safest. Also pushed by investment banks' appetite for commission fees, initial public offerings sharply increased in the 1920s, even for small and medium-sized firms. The context was equally propitious for mergers and acquisitions. At the beginning of 1928, the state passed an important law making capital gains arising from mergers tax exempt. The results were immediate, with the birth of such corporations as Rhône-Poulenc (today Aventis) in chemicals in the summer and Alstom in electrical equipment in September of that year. The total number of mergers rose from six in 1918-1926, to 45 in 1927-1931, and 34 more in 1932-1938.

The role of *holding companies* also grew, notably in upstream-sector corporate restructurings, as these were often created by same-sector companies as means to promote and sell their securities issues.

French firms also tended to intensify their recourse to *inter-company* financing, and this was all the more the case in the 1930s, once bank and stock-market funding became impossible while profits were eaten away by deflation, lower purchasing power and the closure of foreign markets. Inter-company financing could mainly take two forms:

- simple cross-payment facilities (inter-firm commercial credits, with lengthening payment delays visible in the rise in working-capital needs);
- more sophisticated financial constructions (shareholding networks, subsidiaries, holding companies) that created veritable internal, intra-sector or intra-group, capital markets. This type of arrangement enabling insider financing is particularly common in developing countries today. Agosin and Pasten (in Oman, 2003) give an excellent description of such an insider financing network, how it functions, its significance and its limits in Chile.

The multiplication of corporate cross-shareholdings had a double effect. First, it put substantial unproductive financial assets on the balance sheets of large companies and thus further restricted productive investment: 25 per cent of investments made in 1927 by France's five largest chemical, coal and steel companies were in the form of such cross-shareholdings, representing 12 per cent of their total assets; at Kuhlman (now Péchiney), for example, the company's financial portfolio increased from 13 per cent of fixed assets in 1923 to 70 per cent in 1938. Secondly, the multiplication of cross-shareholdings concentrated industrial power into the hands of a few strong firms that were the decision makers at the top of each sector's holdings.

Last but not least, the stock market experience of the 1920s and 1930s would leave a bitter taste in many managers' memory. Before long they would turn to it no more than small investors would.

Role of Public Institutions: Financial and Regulatory Aspects

First, did the state step in when capital markets failed?

Until Léon Blum's *Front Populaire* (1936-1937), successive governments pursued no overall programme likely to stimulate the economy. French firms did not benefit from effective economic stimulation policies (in contrast to the New Deal in the United States, and the arms and infrastructure spending in Germany). The state's first major response to the crisis was a rearmament plan in the spring of 1937. Throughout this period, the fall in global demand and high interest rates completely froze investment. In 1939, production had fallen by 5 per cent compared to 1930, and the war would only aggravate this trend.

Worse, the state in all likelihood exerted a negative influence by attracting the major part of available savings to it (eviction effect): first it collected half of national savings via its Post Office and the Savings and Deposit (*Caisses d'épargne*) networks; second, either directly, or through public and semi-public firms (such as railways), it collected huge proportions of finance on securities markets. Hautcoeur (1996, 1997) estimates for the period 1870-1900 that much of its spending was not very productive, and that the rise in the need to finance the public deficit after 1932 provoked massive eviction of private borrowers in conjunction with a sharp rise in interest rates: the state accounted for about three-quarters of total bond issues between 1932 and the Second World War.

Did the state have any choice other than to provide structurally illiquid markets with massive economic stimulus packages? Would it even have been able to do so? From a strictly financial point of view, the convertibility constraint resulting from strict adherence to the Gold Standard (which was the general rule during the Third Republic) allows serious doubts: under this regime, the state had to limit the quantity of money in circulation to a stable proportion of its gold reserves. This constraint had been removed to face the needs of the First World War and Reconstruction. After partial stabilisation in 1921, that proportion (liquid liabilities/gold reserves) constantly grew until 1928, thus easing the financing of the Reconstruction and amplifying the subsequent investment boom of the 1920s. But monetary stimulation only worked for a decade: stabilisation by Poincaré in 1928 would put a halt to this inflationary process of monetary expansion to preserve the new parity of the Franc to gold (thereby also preparing the deflation of the 1930s).

Second, did the state fulfil its mission as a regulator?

France's public authorities were understandably less interested in anti-trust legislation than in seeking to limit the power of managers running vast share portfolios. In the mid-1930s, a series of laws aimed at improving transparency and accountability in corporate governance were passed. These laws included: prohibition of multiple-class shares; restriction of the number of positions a director could hold; making managers criminally liable; and the introduction of double taxation on holding companies and their constituent members.

Though appropriate according to "good" corporate-governance criteria, these measures were not sufficient to restore much public confidence in the quality of corporate governance, which points up a fundamental question. Could governments with the political will to improve the functioning of corporate-governance institutions fail to take account of the actual distribution of power between corporations? Can a state take up its regulatory functions in the field of corporate governance without also considering the regulation of competition?

To answer this question, we shall first describe in the next section the general state of French markets before clarifying the links between corporate governance and market structures. Then we return to the question of the effectiveness of public governance.

Corporate Governance and Market Structures

Neither Mass Production nor Mass Consumption: The General State of French Markets

In the 19th century, France was composed of small units of production woven into the rural fabric and scattered across the country. This type of proto-industrialisation, and more generally all forces limiting rural depopulation, urbanisation, and concentration of workers, were thought beneficial for social stability in many segments of French society. Faced with limited, heterogeneous markets that were historically run by powerful wholesalers (see Box II.1) who had access to cheap and skilled labour for production activities, entrepreneurs were dissuaded from undertaking large-scale production: the risks of not selling merchandise at profitable prices would have been too large. As a result, however, entrepreneurs could not benefit from the economies of scale linked to large-volume production.

Box II.1. **Traders and Producers**

Until the beginning of the 20th century, England's economy witnessed a similar balance of power that was very favourable to efficient traders who practically ran the markets and had no interest in seeing producers either coalesce or merge. The fact that the French and English economies benefited early on from well-organised domestic markets is clearly not unrelated to their relative "backwardness" in the 20th century. In contrast, during this same period German industrial entrepreneurs wholly embraced the imperfect "emerging" markets in their country which lacked well developed intermediaries (trading or transport companies). Many set up business organisations large enough to overcome obstacles to trade, integrating trading and marketing functions within their firms that the market could not properly fulfil. The rapid development of banking finance in Germany is also explained by this delayed industrialisation. Business bankers were best placed to respond to entrepreneurial needs, while in Great Britain and France independent market intermediaries had already assumed this role of assisting in financing production cycles.

Large manufacturing companies were thus relatively few in number in France, and relatively small compared with the largest American, German and British companies. Those that existed also tended to focus on production of mid-market and especially high-end and luxury goods, reflected by their strong penetration of domestic and international markets in these segments. They were generally most competitive in niche markets such as aeronautics, luxury cars, high quality silk and textiles and luxury goods.

The automobile sector provides a good illustration: its strength was a broad and rapidly renewed product range. Production facilities were flexible, adapted to either small or medium-sized production batches. Peugeot developed 43 models in the 1920s, for example, and in 1934, at the height of the Depression, 84 per cent of Citroën's production was in the high-end category, with three or four versions of each model all destined for wealthy clients. Not a single mass-market car was launched in France until after the Second World War. In contrast, between 1908 and 1927, Ford produced 15 million copies of its single product, the Model T.

Impressed by American efficiency, a few business owners and government officials became convinced that by adopting the same sales and production techniques as in the United States, they would rapidly achieve the same results. Costs, they thought, would be sharply reduced, permitting sales prices to be lowered and demand rapidly to grow (they presumed demand for manufactures to be relatively price-elastic).

By the 1920s some industry owners began to seek to control costs and improve their organisations as well — foreshadowing later trends even to the point of speaking about cutting down on waste and introducing quality controls (e.g. at Michelin and Citroën). In 1938, Louis Renault decided to put in place a “flexible organisation” equipped with modern (i.e. imported) management control and planning methods in order to be able to monitor the company's operations more continuously. The market for organisational consulting exploded. The leader in the field was even a Frenchman resident in the United States whose strategy focused on timing workers to produce an increase in productivity without capital investment (Caron, 1995).

Yet believing that success can be achieved by reproducing “best practice” recipes is often an illusion. Key ingredients of others' success often evaporate when removed from their original context. Indeed, given that the US market for consumer and producer goods had become the world's largest as well as its fastest-growing market from the beginning of the 20th century, extraordinary optimism was necessary to believe that comparable absorption capacities and economies of scale could be attained in the smaller and slower-growing French market⁶.

Why the Narrowness of the French Market?

Several factors contributed to limiting the size and growth of the market in France:

- *A persistent demographic lag:* from 1820 to 1950, France had the weakest population growth in the Western world, as shown in Table II.3.

Table II.3. **Population Growth Rates 1820-1950**
(annual average rate in %)

	United States	Germany	United Kingdom	Italy	France
1820-1870	2.83	0.91	0.79	0.65	0.42
1870-1913	2.08	1.18	0.87	0.68	0.18
1913-1950	1.21	0.13	0.27	0.64	0.02

Source : Maddison (2001).

- *A slow increase in purchasing power:* throughout the 1920s, real income was on average 40 per cent less than in the United States and the structure of household expenses did not change significantly (in the 1930s, sales of domestic appliances were half those of Western Europe). In sum, a real “middle class” did not yet exist in France. This was linked above all to the predominantly rural character of the population: in 1921, three-quarters of the French population lived in the countryside or in towns of fewer than 20 000 inhabitants (Louat and Servat, 1995). Only in 1936 did the national census succeed in reaching 50 per cent of the population, a threshold crossed in 1850 in Great Britain and at the start of the century in Germany. Last but not least, until after the Second World War the French interpretation of “Fordism” stripped the doctrine of its social aspects: employees did not benefit from wage increases reflecting gains in labour productivity, so workers’ consumer demands could not grow proportionately to their potential output growth (Moutet, 1998).
- *The colonial empire* offered ready-made markets, captive consumer markets and abundant, cheap primary products and labour. This was one of the principal causes of resistance to downward pressures on prices (“price stickiness”) and of a latent deterioration in the competitiveness of certain protected industries. In this regard, Great Britain suffered comparable perverse effects linked to colonial commerce.

Firms' Integration and Innovation Capacity Remains Limited

If France's leading companies remained smaller than their Anglo-Saxon and German competitors (e.g. in 1929 the top ten American firms had sales that were on average 20 times larger than the top ten French firms), it was first of all because the narrowness of their markets meant that their expected and actual sales volumes were correspondingly smaller. Consequently, whereas both markets and corporations had matured in the United States, Great Britain and Germany to the point of producing a first major wave of mergers and acquisitions by the end of the 19th century — phenomena that in turn allowed these countries' leading corporations to take advantage of the next 30 years (until the 1929 crisis) to consolidate their production and marketing structures (Chandler, 1990) — companies in France were not yet driven to integrate (Lévy-Leboyer, 1991).

Moreover, powerful corporatist traders' guilds had long stood between firms and markets, mastering the mechanics of trade and distribution that were adapted to the French market. In contrast to German or American companies, which realised in the last decades of the 19th century that they would only survive by forcibly extending their markets, large French companies did not perceive the need to integrate downstream and bring marketing into their firms before the 1930s. Only then, when confronted with some of their distributors' bankruptcies and with more cut-throat competition brought on by the severe economic crisis, did France's larger corporations seek to understand their customers better and to earn their loyalty by supplying them with better quality products. Even then, in other words, they attempted to secure their existing markets rather than opening up new ones.

And when some French firms finally did undertake efforts to differentiate their products and adapt to market imperatives, they often had neither the necessary stock of domestic innovations nor the financial means to pursue costly research programmes. The differences in size (and hence in economies of scale) between French and American or German firms were thus impressive. For example, in 1926, General Electric's R&D budget alone amounted to 70 per cent of the total sales of such major French companies as Thomson-Houston and CGE (Compagnie Générale d'Électricité). In chemicals, the amount devoted in 1927 to R&D by IG Farben was twice Kuhlmann's total sales and thrice those of Péchiney⁷ (Lévy-Leboyer, 1991).

French industry was confronted with the problem of having started early: active for some time, and therefore built up on the basis of older vintages of technology, many French companies could count neither on massive common

research funds (as were organised in Germany under the state's impulse) nor on having vast markets (as in the United States). Lacking adequate financial and commercial incentives, they were largely unwilling to incur the innovation and restructuring costs likely to have assured them a place among the industrial leaders.

The investments of the 1920s, supported by higher profits, access to significant market financing and a healthy entrepreneurial optimism, nevertheless showed that French firms could catch up to the industrialisation levels of their principal competitors quickly, or even overtake them (Table II.4). Engaged in their first real effort at rationalisation at the end of the 1920s, French companies did not long profit from expanding markets, owing to the slowdown of the 1930s and the Occupation from 1940, which cut this process short and delayed the modernisation of French industrial capabilities and market growth until the second half of the 20th century. Indeed, while the productive capacities of the leading industrialised countries operated at full capacity during the Second World War, those of France rapidly headed towards obsolescence. Attesting to a long period of industrial lethargy, in 1945 the average age of machinery in France was 17 years; much of it dated, in other words, from the peak of the last stock market cycle (1927-1931).

Table II.4. Comparative* Industrial Levels of France and Leading European Producers, 1900-1939

	Coal	Steel	Electricity	Cement	Phosphates	Dyes	Automobiles
1900	0.17	0.36	0.40	-	1.72	-	-
1913	0.23	0.48	0.61	0.46	1.91	0.04	2.71
1930	0.36	1.42	1.35	1.08	3.60	0.40	2.40
1939	0.33	0.66	0.60	0.62	1.49	0.41	1.03

Note * average production per capita in France / average production per capita of the three leading European countries (excluding France).

Source : Lévy-Leboyer (1991).

The Organisation of Markets Reinforced the Concentration of Economic Power

French laws dating from the Revolution clearly banned inter-company agreements and cartels⁸. Yet both were widespread by the end of the 19th century (with about 100 cartels in existence at the beginning of the 20th century). How can this contradiction be explained?

Freedeman (1993) gives the answer:

“In the context of falling world prices from 1873 to 1896, a major motive for cartels [worldwide] was to escape the rigors of competition and maintain prices at a remunerative level...by substituting the ‘visible hand’ [of cartels] for the unstable free market. [...] In the United States, the common law and the Sherman Anti-trust Act of 1890 precipitated the creation of giant holding companies and consolidation by mergers into single companies to escape legal prohibitions. [...] In France, Article 419 of the Penal Code (1810)...prohibiting any interference with the natural play of market forces in determining the level of prices posed a barrier to modern cartel arrangements. [...] However, judges and other public officials were suspicious of the free-market model, which they saw as disruptive of the social order. So the courts and the government eventually adopted a tolerant attitude toward cartels that provided market stability and used their power over prices with moderation.”

Often called “syndicates” (*comptoirs*) or “committees” (*comités*), cartels acted as permanent administrators of agreement networks, systematically organising the markets of each branch of the upstream sector (coal, steel, petroleum, textiles), i.e. sectors where product homogeneity eliminated the need for strong differentiation via marketing (Lévy-Leboyer, 1981). They also became important in the sugar, paper, glass and chemical industries. In the two latter sectors, Saint Gobain dominated the cartels. In 1890, Saint Gobain was participating in 19 different cartels.

The cartels apportioned production among member companies to bring supply in line with demand, divided markets among them, advised potential buyers, organised sales and distribution through a common agency, and controlled prices, subsidising them if necessary. By supporting prices in the domestic market (and, in consequence, profits) they facilitated investments, limited losses when sales were difficult, and above all, institutionalised communication between firms in the same sector. Firms thus developed the habit of listening to and negotiating with each other, thereby greatly facilitating intra-sector co-operation and links (e.g. the merger between Péchiney and Ugine in chemicals), openly anti-competitive “corporatist” arrangements, and the exertion of pressure on public administrative and political personnel.

Despite strong tension between different pressure groups (leading for example to the dissolution of the steel cartel in 1930 when members refused to pay the penalties they owed for having exceeded quotas), agreements

multiplied. Acting as a barrier to entry in sectors incapable of restructuring, these agreements benefited the biggest groups. Thus sheltered on the domestic market, these groups were free to pursue their own investment programmes (conquering external markets, renewing productive capabilities, or acquiring equity investments in other firms in the sector thus ensuring either control or influence over them).

As a result, apart from certain clear monopolies (such as Michelin in tyres or Alstom in electrical equipment), most major industrial sectors saw their *oligopolistic* structures reinforced: in chemicals, glass, petroleum and automobiles, the leading three companies accounted for between 60 and 70 per cent of production (Houssiaux, 1958). Most small and medium-size family-owned enterprises and small rural businesses, on the other hand, operated in markets characterised by relatively low barriers to entry and exit, considerable price competition and thus limited profits – what economists refer to as “monopolistic competition” and many others call “shopkeeper” capitalism. In retailing, legislation dating from the mid-1930s protected small businesses from the competition of large chains and department stores. Rather than having to engage in selective competition, a large number of companies and industries thus benefited from privileges and protections (tax exemption, tariffs, subsidies).

Consequently, the generalisation of rent-seeking behaviour rendered unlikely a widespread implementation of low-cost/high-volume strategies that would have implied corporations’ willingness and ability to cut prices. The heterogeneity and lack of dynamism of the domestic market were thus both cause and effect of the prevailing governance structures oriented towards rent-extraction. The competitive structure of markets and the organisation of firms (as well as the latter’s governance systems) were mutually reinforcing. Unchecked, this interaction resulted in the tying up of both markets and corporate governance institutions for the benefit of those private interests that were best organised. A similar logic operates in many developing countries today (or has in their very recent past)⁹.

Yet is it not the role of the institutions of public governance to regulate the interplay of private interests for the preservation of public order and the common good? How did they perform this mission, and within what constraints?

Role of Public Governance Institutions

In a country that since the Revolution in 1789 had seen successively three republics, two empires and two monarchies, punctuated by bloody revolutionary periods, the Republic remained an uncertain democracy. The

young Third Republic (1870-1940) was thus as preoccupied with organising and stabilising its electoral base as its financial supporters. This prudent strategy inclined the regime towards systematically reinforcing those social structures favourable to its own longevity, and in so doing, it sometimes neglected to provide the country with the tools necessary for its modernisation.

The Third Republic thus multiplied its efforts on behalf of the rural population for both tactical and ideological reasons. With the vast majority of the population living in the countryside, it was there that the largest possible electoral base could be built. Many politicians were themselves of rural origin and were often imbued with physiocratic notions of the land as the sole source of wealth, and urbanisation and industrialisation essentially being factors of social disintegration and moral destabilisation. Hence the ambiguity of the state towards industrial modernisation throughout the 19th century (Lévy-Leboyer and Bourguignon, 1985). France long retained traces of these rural roots: a strong Ministry of Agriculture (created in 1881), protections for small businesses and agricultural holdings (such as the 1892 *Méline* customs tariffs), the co-operative network of local branches of the *Crédit Agricole* set up in 1894, multiplication of small roads (*chemins vicinaux*) and of very local railways.

With the same intention of stabilising the regime, primary education became compulsory and teachers were transformed into missionaries of the Republic. In higher education, emphasis was also placed on general culture. But this practice occurred to the detriment of technical skills and knowledge. The first university course in electricity was offered only in 1892. And if 2 000 students were admitted in 1850 to France's best scientific institutions of higher learning (the *Grandes Écoles*), 60 years later the number had only risen to 2 500¹⁰ (Caron, 1995).

Up to the eve of the Second World War — and contrary to the belief apparently held by many abroad that France has been dirigiste (“Colbertist”) virtually since the 17th century — the regime was only mildly interventionist. With the exception of the First World War and the second half of the 1930s, the state largely adhered to a liberal economic doctrine and its interventionist motions generally provoked hostile reactions from the majority of intellectuals and managers. Yet these limits to state intervention were as much if not more due to a lack of knowledge of, and a presumption of state impotence in the field of economics (economic “laws” were largely considered as “natural”, i.e. beyond human reach) than to a deliberate programme of non-interventionism (Rosanvallon, 1990).

The importance of employers' organisations in the financing of both elected officials and the state, notably the very powerful *Comité des Forges*¹¹ (Steel and Iron Syndicate), likewise worked to orient political measures towards preserving the balance of power and social structures (Garrigues, 2002). Although corporatist agreements had been banned since 1791 during the Revolution, the Third Republic's policy of social appeasement led to their being reinstated, either *de jure* or *de facto*, both in the case of labour unions and producer organisations. A law voted in 1926 (following a distinction first made by a court in 1894 between "good" and "bad" ententes and the unambiguous evolution of jurisprudence since 1902) even encouraged these organisations to declare themselves by acknowledging the legitimacy of "good" agreements among producers reputedly beneficial to the general welfare (*l'intérêt général*). "Cartels were an [insidious] form of concentration that avoided, at least temporarily, the advent of the American style giant holding company or the giant centralized corporation for which there was great public hostility. Apologists stressed that *comptoirs* were a better and a more 'French' solution to the exigencies of concentration" (Freedeman, 1993).

Yet the events of the 1930s highlighted, above all, the Republican state's impotence (simultaneously financial, social, ideological and technical) in managing the crisis. If the administration sought to encourage investment and induce a rise in purchasing power, the emergence of large markets, etc., it never gave itself the means to do so. In the institutional setting that prevailed, remedying the shortfalls of private finance or establishing healthy competitive and corporate-governance structures would practically have been Mission Impossible. Both the leaders during the post-Second World War period and their electorate would remember this.

Conclusion

Economic rationalisation in France first took the form of establishing strong capital-intensive links among companies with complementary activities (insider finance networks) and cartels among competitors, rather than of concentrating activities through corporate mergers. These practices in fact served as a substitute for consolidation. The country witnessed a double concentration of power: in capital markets (equity investments, holdings, subsidiaries), and in product markets (agreements, cartels, syndicates). The oligopolisation of the economy in France, as in several developing countries

today, took place through market structures — in both capital and product markets — rather than through corporate mergers and concentrations as it did in the United States.

Powerful private interest groups tended to entrench themselves and perpetuate their rents through the country's economic and political institutions, and most businesses became accustomed to operating in non-competitive domestic and colonial environments.

Together, these forces:

- resulted in higher prices;
- encouraged the persistence of inefficient firms;
- limited the potential learning effects associated with vast markets, especially in terms of organisational, production and marketing know-how.

The absence of mass consumption meant that French companies had little incentive to run the long production cycles likely to give them the same benefits of economies of scale and scope as their Anglo-Saxon and German competitors. At the same time however, the practices born of the country's markets and of its corporate governance institutions meant that French companies had little incentive to reduce their prices or raise salaries, which would have helped translate productivity gains into a rise of aggregate demand, which could have in turn contributed to the creation of the very mass-consumption markets French businesses so sorely lacked.

As perceptions of capital-availability and market-size are among the first determinants of entrepreneurs' expectations in assessing business potential, the limited perspectives of both meant there was little incentive to invest. Although it is difficult to measure the cumulative effect of the institutional interactions highlighted in this chapter, it is clear that the prevalence of oligopolistic vested interests, which lacked any overarching coherence, weighed heavily on the country's development.

Notes

1. The word *corporation* was used in French to designate especially professional groupings of artisans and other tradespeople, i.e. guild-like organisations.
2. General partnerships (*sociétés en nom collectif*) are simple associations of people individually and collectively liable for company debt. This was the most common form of company in the 19th century, typically adopted by modest family firms whose capital needs were met by reinvesting profits and by the contributions of a limited number of individuals; 80 per cent of companies created between 1840 and 1880 adopted this legal form. Limited partnerships (*sociétés en commandite*) assemble two categories of partners: active partners who manage the company with unlimited personal liability; and sleeping partners who are simple financial investors, liable only to the limit of their investment. Until 1932, the withdrawal of a partner triggered the dissolution of the partnership. A legal decision that year permitted the issuance of “bearer” shares (as opposed to “registered” ones), forming the basis for joint-stock limited partnerships (*sociétés en commandite par actions*). The sleeping partners’ shares were freely transferable and could be listed on the stock market. This type of company, which cost nothing to create, was very popular with large companies and it substantially contributed to the First Industrial Revolution (family management but sizeable assets). Their importance diminished after 1867 following the liberalisation of laws regulating the formation of joint-stock companies (*sociétés anonymes*).
3. The same distrust existed until the mid-19th century in Common Law countries. In Great Britain, following a period of uncontrolled speculation, the “Bubble Act” adopted in 1720 decreed that the creation of all new joint-stock companies had to be voted in Parliament! In practice, the form of joint-stock company was reserved for public utility projects (canals, railways etc.) until the mid-19th century (Hunt, 1969). In the United States, the idea was similar: to facilitate public projects that the state could not or did not want to finance alone. Connecticut in 1837 and New York in 1846 were the first to decide that joint-stock companies were socially beneficial, especially in that they raised living standards and taxable income and were useful in limiting westward migration. These effects underlay their decision to approve the creation of joint-stock companies for any legitimate reason (Seavoy, 1982). Opposition from both the legal tradition and prevailing mentalities made this process much more drawn out in Europe.

4. This liberalisation of control in creating joint-stock companies expanded rapidly in Continental Europe, as states engaged in competitive legislation in order not to hamper resident companies' ability to compete. It reached Spain in 1869, Germany in 1870, Belgium in 1873 and Italy in 1883. This effect was similar to that seen in the United States in the competition among states to attract firms to incorporate in their state — competition described by some as a “race to efficiency” and by others, notably including Supreme Court Justice Brandeis (who coined the term), as a “race to the bottom”.
5. In the last third of the 19th century, companies were being formed rapidly in Germany. In order to avoid speculation, the Reich passed a law in 1896 banning the sale of joint-stock company securities during the year following their issuance. As German markets were not highly developed and large specialist banks controlled access to the market, these banks found themselves obliged to accompany all new companies throughout their first year of operations. It is easy to envisage the positive spin-offs from this situation for the relationship between firms and banks: greater understanding, mutual trust and quality expertise. In 1914, representatives of the banking profession held one fifth of all directorships in the country's large corporations (Verley, 1994). In other words, the participation of banking institutions facilitated the development of securities markets, which in turn further reinforced their role. Capitalism does not perforce entail the opposition of banks and markets, quite the contrary.
6. A good example of misjudging the market is that of the car manufacturer André Citroën. On a brief upswing in the market in 1933, the company launched an ambitious investment programme aimed at boosting the market. One year later, it was staggering under debt, having to finance rapidly growing inventories and to bail out its domestic and foreign subsidiaries. It was declared bankrupt at the end of 1934. Citroën thus paid a price for overreaching ambitions, which despite all of its efforts at innovation and promotion, could not be fulfilled by the limited absorption capacity of the French market. In June 1935, Michelin took over Citroën and its shareholders were obliged to accept a 60 per cent capital loss.
7. In the absence of a state-supported research policy, one effect of the crisis of the 1930s was to push French firms to collaborate with foreigners (particularly Americans). Cross-licensing, exchanges of patents, research missions and joint subsidiaries created a real pool of innovation and development for the firms most involved in international markets.
8. The law of 2-17 March 1791 on Freedom of Commerce, Articles 1131 and 1133 of the Civil Code (1804), and Article 419 of the Penal Code (1810).
9. Particularly in Latin America. See the case of Brazil analysed in Oman (2003).
10. This relative penury of qualified workers reinforced the advantage for the leaders of various industrial sectors of introducing new management and production techniques.

11. Founded in 1864 by the representatives of France's ten largest metallurgical groups, this organisation, which was both a cartel and an employers' association, extended its hold on the country's political, economic and journalistic milieus until the 1930s. It was so successful in this that it has been described as a "state within a state" (Milesi, 1990).

*Chapter III***The *Trente Glorieuses*:
Emergence of a Governance Focal Monopoly****Summary**

Considering the oligopolistic concentration of power and the interwoven non-economic factors in France's corporate-governance structures during the *Trente Glorieuses* (1945-1973), why was national development not blocked during these years?

To understand the French corporate-governance paradox one must look at the functioning of corporate governance within the nation's broader governance culture. Only then is it possible to see how the country's institutions of corporate and public governance became so closely aligned that a governance focal point could emerge. The state established itself as the sole and uncontested, or monopolistic, focal point at the heart of the formation of economic and social compromises, and was thus able simultaneously to subordinate the majority of private interests to the national interest, and buy their co-operation at minimal cost. This process established a public focal monopoly over governance relationships in France.

Development processes largely benefited from the capacity of corporate- and public-governance institutions to impose coherence on economic interests — particularly through suitable incentive structures — and produce a high level of confidence throughout society.

Introduction

The traumatic experience of two world wars and the crisis of the 1930s, with economic, political and moral bankruptcy and the state's powerlessness in controlling private interests, all had a profound influence on the men charged with building France's post-war institutions. The 1944 programme of the *Conseil National de la Résistance* (National Resistance Council) was overtly interventionist. It believed it necessary "to do away with the great economic and financial fiefdoms of the economy's management" and to organise "the return to the nation of the great monopolised means of production".

At the beginning of the 1950s, as new uncertainties linked to the Cold War and colonial independence began to emerge, the majority of observers predicted that France would soon return to the stagnation and instability of the 1930s¹. What happened, on the contrary, was that economic performance progressively improved to the point where the economy was among the fastest growing in the world by the end of the 1960s (Table III.1). This success constituted a true miracle for a country universally condemned just ten years earlier by historians and economists as being hopelessly backward and shackled with excessively risk-averse elites (Landes, 1957).

Table III.1. Average Annual GDP Growth (%)

	1955-1968	1968-1973
Japan	9.5	8.9
France	5.1	5.6
Germany	4.9	4.6
Italy	6.3	3.9
United States	3.9	3.5
United Kingdom	2.8	3.4

Source : Maddison (2001).

Explaining Growth During the *Trente Glorieuses*

Econometric studies of France's growth during the *Trente Glorieuses* have not managed fully to explain the "miraculous" character of growth during this period: they all highlight the importance of a residual in the growth-accounting statistics that cannot be explained by the accumulation of factors of production (human, physical and financial). This residual is termed "total factor productivity" (TFP) but it is as much a reflection of the efficacy of the combination of factors of production as of the incapacity of economists to explain growth satisfactorily (see Annex 1). Depending on the study, TFP accounted for between 50 per cent (Carré *et al.*, 1972) and 73 per cent (Denison, 1967) of France's economic growth during the 1950s and 1960s.

A critical examination of the Carré *et al.* (1972) study — detailed here in Annex 1 — suggests that the size of the contribution of TFP reflects phenomena that are essential to understanding cumulative development mechanisms in the country, and help explain why growth eventually spread to all parts of the nation's economy — even those that were most protected.

The acceleration of industrial growth between 1968 and 1973 is largely attributed to TFP. Such a relationship suggests that the effects of the development factors that are the focus of this study reside amongst the growth's least understood and least quantified aspects. More explicitly, these effects are the transformation of corporate-governance institutions, interacting with those of public governance and together determining how well the nation's market system functions. It is perhaps not without importance, for example, that France was the only Western country equipped at the time with an administrative body charged with "planning" growth — or that one of the country's highest-ranking civil servants insisted at the start of the 1960s on "the necessity of a better link between companies and the Plan" (Bloch-Lainé, 1963). But how, from an economic perspective, should one interpret the existence and assess the role of such an administrative body?

A good place to start is with the conclusions of Nobel Prize winner Douglass North (1990, 1994) in his attempt to enrich growth explanations based on the accumulation of factors of production by including a systematic analysis of the role played by institutions — the formal and informal "rules of the game" in an economy — and their transformation. North's focus is thus on variables not necessarily emanating from the economic sphere but nonetheless playing a major role in economic development (see Box III.1).

Box III.1. North and the Role of Institutions

Standard growth-accounting and neoclassical economic analysis encounters severe problems in explaining the history and variations in the economic performance of nations. This difficulty is no accident. A good example is the assumption of rationality, which is interpreted to mean, for example, that the elite of a country whose economic performance is deteriorating, once aware of the problem, will almost mechanically move to modify appropriately the rules of the game in their country in order to stabilise the economy; the absence of such a move is in turn interpreted as demonstrating either the country's elites' incapacity or lack of willpower to improve the situation. Yet history often shows, on the contrary, that there is nothing automatic about the formation of efficient economic institutions (especially those of markets whose existence neoclassical theory simply assumes). The necessary conditions for a productive and well-functioning economy emerge from long and complex economic, social and political processes. The economic transformation of a particular country is best understood as the fruit of institutional, technological and demographic changes.

"Recent neoclassical models of growth built around increasing returns (Romer, 1986) and physical and human capital accumulation (Lucas, 1988) crucially depend upon the existence of an implicit incentive structure that drives the models (...). To attempt to account for the diverse historical experience of economies or the current differential performance of advanced, centrally planned and less-developed economies, without making the incentive structure derived from institutions an essential ingredient, appears to me to be a sterile exercise." North (1990), p. 133.

Studying corporate-governance institutions from this perspective thus provides an opportunity to cut to the heart of a country's development mechanisms and to explain some of their dynamics that are observed only rarely and with difficulty. It also requires that the incentive structures acting on the country, sector or particular group of actors be taken carefully into account.

We will thus examine the content and structure of the incentives derived from French corporate-governance institutions in an attempt to shed new light on the technological, organisational and institutional progress that made the country's rapid growth possible. Because the term "institution" immediately invokes the notion of stability, we must nevertheless guard against the temptation to study institutions outside their temporal context, presuming to know, *in abstracto*, the motives and desires of shareholders, bankers, managers,

regulators, etc. In the long-term analytical perspective that is ours, an institution is never more than a *momentary compromise*, a more or less dynamic balance of interactions. An institution would be described more adequately as a continuous *institutionalisation process*, both conditioned by historical context (e.g. the economic, legislative, ideological environment and relations of power among and within social groups) and integrated as partially endogenous into their decision-making frame of reference by individuals and organisations possessing a degree of power in society. These institutional dynamics can be identified according to whether their field of operation is predominantly economic (see section on the Concentration of Economic Power in this chapter) or political (see section on the Formation of a Governance Focal Monopoly also in this chapter).

Concentration of Economic Power

After a brief look at the new trends arising in 1945, our focus will turn to the stronger factors (both internal and external to corporations) affecting the overall concentration of power in the French economy.

A New Start: the Immediate Post-War Period

As early as the late 1940s and early 1950s, several factors altered entrepreneurs' incentives and loosened the constraints that had previously impeded the cumulative processes of economic development from gaining strength.

- *A new entrepreneurial spirit* had emerged with Liberation, as reflected in the number of new businesses created: 12 700 in 1929; 7 700 in 1939; 17 700 in 1945; and 38 000 in 1946.
- *The loosening of financial constraints*: the injection of massive public funds in conjunction with active redistribution policies (the Welfare State), and the lifting of household and business reticence to borrow in the context of inflationary reconstruction.
- *The loosening of market constraints*: growing urbanisation, demographic renewal caused by the baby boom, the growth of wage labour, the indexation of wages to productivity gains, the imminent opening of European markets and, above all, the explosion of potential demand (in housing, domestic equipment, consumer goods) long checked by years

of economic and psychological depression. The combination of these factors marked the arrival of real mass-consumption demand for the first time in the country's history.

- *The growth of productivity*: companies did not hesitate to solicit the advice of American consulting firms or experts, who diagnosed a clear lack of knowledge and capability in mass production. At the beginning of the 1950s, over 3 000 people were sent to the United States on “productivity missions” to study the management practices of large firms². American influence was felt everywhere: in machinery imports that facilitated rapid technological deployment and in new marketing, management, control, production-organisation and R&D methods. Renault's 4CV and subsequently Peugeot's 203 models, constructed on large automated and integrated production lines to reduce costs, were emblematic of the start of mass consumption.

Legal Heritage from Vichy Concentrated Power in the Hands of the Chairman-CEO

The crisis, scandals and bankruptcies of the 1930s provoked a heated anti-capitalist reaction, with mistrust of large companies, set against the background of the political Left's condemnation of the exploitation of the proletariat and a part of the Right's attachment to a traditional and agricultural France. Many saw limited-liability joint-stock companies as both irresponsible and corrupt, and on the eve of 1940, some considered ways of introducing criminal liability for managers in cases of fraud, negligence or careless management (62 years before the adoption of the Sarbanes-Oxley law in the United States!). These reformers believed that managers should be made liable for the company's solvency with their personal assets.

In 1940, the ideologues of the authoritarian and collaborationist regime of Vichy (1940-1944) held that the only alternative to the collective irresponsibility of shareholders was the personal liability of managers. But corporate managers and directors considered that the loss of social standing and the financial liability attached to business failure were unacceptable, and as the Vichy government sought to accommodate them, the proposed bill was modified. While submitting managers to a legal presumption of fault without proof of the contrary, it clearly formulated the role assigned to the company head: “In the economic domain, as in the political, the notion of the responsible head has to be established, the mission of deliberating bodies being no more than one of consultation or surveillance” (quoted in Peyrelevade, 1999). In

1940, a new concept was thus introduced in French corporate law: that of *président-director-general* (PDG), i.e. Chairman-CEO. It would henceforth require companies to combine the roles of managerial responsibility and shareholder-representation in one individual. Chairmanship and Chief Executive Officer became two inseparable functions³. This feature made French corporate-governance institutions a unique case of legal obligation to concentrate power in a company.

This legacy remains largely intact in the relevant legal texts today. The company law voted (by the Gaullist parliament) in 1966 endorsed the possibility of a separation of powers by a structure composed of a management board and a supervisory board. But the acts passed by Vichy were left untouched and phrasing such as “the Chairman of the Board of Directors assumes responsibility for the management of the company” remained in place. While this dualist structuring of power had the merit of existing on paper, in practice it remained largely inoperative until the very end of the 1990s.

The list of ambiguities does not end there. The board (Art. 98) and the chairman (Art. 113) were both invested with “the widest ranging powers to act in all circumstances in the company’s name”. The board is supposed to name, control, and even dismiss its own head. Directors’ remuneration levels are set by the board (Art. 110) but need not even be *reported* either to the auditors or the assembly of shareholders – much less approved by a vote of shareholders. Better still, the chairman’s remuneration, which as an agreement between the company and a member of the board should entail a procedure to avoid the granting of unwarranted benefits (Arts. 101 and 103), is instead recognised by the jurisprudence of 1970 as a *unilateral* act of the board.

If one adds to this overall picture of boards the very high number of reciprocal obligations and high degree of cultural homogeneity among their members (same education, networks, values) (Birnbaum *et al.*, 1978), one would have to question the strength of the incentives for effectively controlling Chairmen-CEOs’ behaviour. In fact, this institutional configuration permitted them to set up and preserve their personal power beyond all control.

Dynamics of Competition and Regulation Favoured the Large Groups

1) Heritage of the 1930s and Vichy

The post-war environment remained profoundly marked by the rent-seeking structures implanted in the economic landscape during the crisis years of the 1930s and 1940s. Anti-competitive and financial alliances remained

strong, reflected in the persistence of cross-holdings and coalitions of industrial and financial interests⁴. On average, each of the leading 100 firms had nine financial links to other companies at the start of the 1950s.

Moreover, the negotiations to organise the markets that had become quite heated in the 1930s (in efforts to preserve market shares and avoid price wars) became firmly institutionalised by the Vichy government in 1940. The regime's "*Comités d'organisation*" (Organisation Committees) assembled members of the same profession so that they could jointly determine production costs, sales prices and profit margins to be proposed for approval by the *Direction des Prix* (Price Control Directorate). Employers' and farmers' associations were among the most powerful. As a result, at the end of the war, it was "neither [free] market prices nor production costs that serve as the basis for market transactions, but prices set by the agreements." (Houssiaux, 1958)

Faced with such rent-seeking activity, and in contrast to Germany and Japan (where the Americans had dismantled the majority of collusive structures), France's post-war public authorities opted to avoid both direct confrontation and brutal adjustment shocks. Prior to 1958, whether this choice reflected prudence or powerlessness is uncertain. True, a decree was passed in June 1945 regulating individual sales practices and aimed at warding off the deleterious effects of "ententes and dominant positions". Yet this reform measure, undertaken in a context of impoverished markets and unaccompanied by coercive measures, was little more than a futile gesture.

2) The Fourth Republic (1946-1958): Prudence or Impotence?

The Fourth Republic undoubtedly had the intention of stabilising French capitalism, notably by setting up a "technical commission on ententes and dominant positions". Yet the commission's operations were totally hampered by a combination of factors: a lack of means (only a dozen staff), employers' lobbying, senior civil servants' being persuaded that ententes could favour economic development, the lack of a clear mandate regarding its powers and which ententes to target, and a general lack of continuity in policy, with governments succeeding each other on average once every seven months between 1944 and 1958.

In 1953, the *Commission des Comptes de la Nation* (National Accounts Commission) established that "the absence of competition permits a vast swathe of small obsolete units to subsist alongside a small number of highly lucrative companies [...] the national economy is no longer driven by profits

but is tending towards a rent economy". The Commission primarily targeted protectionism and such widespread obstacles to competition in domestic markets as guaranteed price floors, price discrimination according to the buyer, market-sharing agreements, all sorts of subsidies particularly in agriculture, artificial supply restrictions, tolerance of tax fraud, etc. In 1954, another report, produced by the President of the Commission and known as the Nora Report, overtly targeted the powerlessness of the state vis-à-vis the business community: "In attempting to confer a privilege on each, one no longer favours any. Instead, one establishes a regime where intervention becomes synonymous with anarchy, rather than order, and where competition for political influence replaces market competition" (cited in Jenny and Weber, 1976).

Even more precise, Houssiaux (1958) remarked that the large groups dominated their respective sectors, and smaller companies relied on these decision centres to define their strategy: "Despite a structure of production characterised by too little concentration, the majority of business in France is more or less directly under the control of large companies." The large business groups did not stop at their legal boundaries, in other words, and constituted a private decision-making centre of power over much of the economic fabric, which they controlled "more or less directly". For public officials, the ability to exercise influence over such large companies and their business environment would mean that they could gain considerable leverage to shape the economy. This fact did not escape General de Gaulle.

3) De Gaulle's Programme Ambiguities (1958-1969)

On his return to power in 1958, and confident thanks to the establishment of the new presidential regime that he was not under excessive time pressure⁵, de Gaulle charged two of his top bureaucrats to produce a report on the "obstacles to economic expansion". This report created a certain awareness that transcended both particular interests and political rifts. Several fiscal and legislative reforms followed, resulting in the dismantling of protections enjoyed by small businesses and thus creating a new market for large commercial outlets which then developed very rapidly (such as Leclerc and Carrefour). On the matter of competition between large groups, the two reformers were surprised by the very small number of inquiries launched by the technical Commission into the widespread anti-competitive practices such as quotas, price agreements and barriers to entry.

While the 1950s and 1960s witnessed the expansion of large French business “groups”, the accelerated movement towards regional integration under the Gaullist government is very clear in the second half of the 1960s. Contrary to a large proportion of employers and of the nation’s political leaders, de Gaulle firmly believed in Europe *and* in “the greatness of France” within Europe. His doctrine was liberal *and* interventionist; markets should be regulated by the forces of competition rather than by arrangements and protection, but modernisation should be orchestrated by the state.

From 1960, de Gaulle launched a policy of large projects (the rapid Paris metro RER, the supersonic Concorde, the Roissy airport...) and reinforced his commitment to creating internationally competitive French business groups, even if they became oligopolies and monopolies in the domestic market. According to spokesmen for the Fifth Plan (1966-1970), “the national champions” – conceived as instruments of national modernisation – required “sufficient supplies of capital to be able to take on competition wherever it arises, to invest abroad, to have their own research centres and techniques and to have the capacity to negotiate [international] deals on good terms”. It was thus necessary “to strengthen the competitiveness of French industry by speeding the creation or development of internationally-sized business groups with French capital formed by integrating companies technically, commercially and financially. [...] In many sectors, this integration should lead to a limited number of such groups, perhaps exceptionally going so far as the creation of a single dominant group, which, given the opening of borders, would not have the same disadvantages as in a protectionist regime” (cited in Caron, 1995).

How could one instil respect for the rules of fair competition in the domestic market when the primary objective of the Gaullist government was to encourage the formation of strong industrial groups (“national champions”) capable of standing up to international competition, even if it meant protecting them in domestic markets? This dilemma is echoed by the challenge faced more recently by a number of developing or emerging countries, such as Korea or Brazil, in deciding how to regulate their national giants⁶.

Finally, it was in the framework of the European Common Market that the new rules of competition would increasingly be determined. Since the 1960s, the strengthening of legislation against ententes (with the European Commission and the European Court of Justice enforcing it) and the arrival of direct competition in domestic markets have acted as powerful incentives to modernise and to accelerate firm concentration⁷.

The growing difficulty of forming ententes, the need to withstand intensified competition by businesses in so-called “exposed” sectors (i.e. no longer benefiting from protection in the framework of the Common Market), and the use of public incentives (loans at reduced interest rates from 1955, tax measures in 1965 and 1967) were all converging to create a strong rationale for “big business” to consolidate. Until the mid-1960s, company regroupings still gave priority to consolidating existing networks and positioning these on strongly growing markets (even if this meant diversifying and spreading risk by creating new joint subsidiaries). Increasingly however, the rules of a new competitive universe came into effect. These dictated that competition operate on cost/volume strategies, strongly promoted by administrative and political officials. Mergers and acquisitions understandably accelerated: 61 per year between 1950 and 1958; 166 between 1959 and 1965; and 213 between 1966 and 1972 (then the highest rate of mergers in Western Europe). In 1970, 0.6 per cent of all businesses with more than six employees (the 235 biggest groups) accounted for 62 per cent of investment, 45 per cent of sales and 39 per cent of the labour force (Caron, 1995).

The study of the competitive, ownership and legal structures of French capitalism during the *Trente Glorieuses* enables us to conclude without hesitation that a strong concentration of *economic* power existed in the heart of each corporation and each sector.

What, however, was the role of *public* governance institutions in this transformation?

The Formation of a Governance Focal Monopoly

The State Did Not Impose Itself at the Heart of the Economy in One Day

Without returning to the origins of the state tradition in France, it must be underlined that the transition towards an interventionist state was not accomplished from one day to the next (in 1945) as the “mythology” of the Reconstruction would have it. The state had long managed a certain number of economic goods and activities (tobacco, matches, the post office, telephones, telegrams, arms, the *Caisse des Dépôts et Consignations* (Deposit and Consignment Offices) created in 1816, and the *Crédit Foncier* founded in 1852). Two more “preferred” banking institutions were created to respond to the needs of the first post-war period: the *Crédit National* in 1919 and the *Caisse*

Nationale du Crédit Agricole in 1920. State control prevailed again when the recession of the 1930s threatened sectors or companies whose importance was considered to justify public support (petrol, airlines, naval transport, banks). These interventions were facilitated by the competence of civil servants in the technical ministries, particularly the engineers from the *Grandes Écoles* under whose responsibility entire sections of the national economy were placed⁸.

Traumatised by the strikes of 1936 and the socialist experiment that followed (the Popular Front created the 40-hour work week, the first paid holidays, and the nationalisation of the *Banque de France*⁹), fearing the “Workers Revolution” and the incapacity of the Third Republic to protect them, and admiring the German Reich’s technical prowess, the minority of industrialists and bankers who controlled the French economy in the 1930s did not wait for the Vichy regime’s request for active collaboration in 1940 (Lacroix-Riz, 1999). Civil servants, for the most part, also adapted to the new regime: “The elite to which we belonged was not so attached to democracy as to refuse categorically a somewhat authoritarian experiment for the sake of the public good... If the French administrative corps was generally rather indifferent to the ending of democracy, it was because, previously, its main concern was efficacy” (Bloch-Lainé and Gruson, 1996).

The effects of the Vichy regime were ambivalent: it enclosed the French market in a narrow corporatism, yet it created institutions that would be conserved, whole or with small modifications, long after. Its goal in 1940 was two-fold: renew the social and economic structures of the country, perceived as having caused the defeat, and keep the Germans from taking direct control of the nation’s productive apparatus. To give the enemy only a single intermediary with which to negotiate, an array of management, control and economic forecasting organisations was rapidly put into place. Among these were some of the key institutions of the post-war period, including, for forecasting, the ancestor of the *INSEE* (National Institute for Statistics and Economic Studies), itself officially born in 1946; the Treasury, to be responsible for state finances; and the very powerful Economics Ministry. Importantly, they all relied on a newly created link with civil society: 231 organising committees (“*Comités d’organisation*”) in which representatives of each sector (covering 1.8 million companies in 1945) were invited to participate in policy formulation.

This method of governing was a decisive step in transforming the French state apparatus, not in terms of its results (Vichy was characterised by collaboration, financial pillage, exhaustion of the productive apparatus, explosive growth of the black market), but in terms of its legacy to future

governments. It bequeathed to them a new model of governance that institutionalised a close dialogue between the economic oligarchies and the administrative apparatus, thus drawing the private-sector elite into policy debates and implicating them in achieving policy objectives.

Institutional Innovations

The time for self-criticism came in 1945, and many dreamt of a social and economic recovery founded on new values. French society was looking to the future and the effort required for reconstruction with a radical desire to modernise. The elites' behaviour having been questionable during the war, it was felt that the state, provisionally led by General de Gaulle as head of the Resistance, should rule with a firm hand. Yet the core of the system of corporate governance was not put into question. On the contrary, France's post-war leaders drew on the existing institutions and skills, converting them to the double objective of democracy and reconstruction¹⁰. It was in this context that the great post-war "structural reforms" took place through which the state would stamp its mark on the core of corporate-governance institutions, and lay the ground for future social compromises, which still impregnate France today. Four were particularly important:

1) The *Planning Commission* was created to facilitate the organisation of a "concerted economy", thought of as a system of continuous collaboration among the state, workers and employers, and fostered by the dream to be done with social conflicts (Kuisel, 1981). The idea came from Jean Monnet, the future "father of Europe", who explained: "From one administration to another, from one branch of industry to another, people [previously] spoke to each other but their respective intentions remained secret and unco-ordinated. [...] We had to induce private initiative to bend of its own will to the needs of the collective interest, and the best way to do this was to associate all powers in the country in the search for the common interest, for which none alone held the formula but each held a part" (Monnet, 1976). In 1946, with the support of General de Gaulle, Monnet created the *Commissariat Général du Plan* (General Planning Commission – CGP) to serve the objective of *policy coherence and economic growth with social cohesion* (see Box III.2).

The CGP's first actions were to channel available credits and supplies towards priority sectors. During its first four years, it provided 50 per cent of the nation's total capital investment (Hall, 1986). Funds were allocated to private firms in exchange for the signature of "quasi-contracts", by which they

had to submit to the Plan's allocation strategy. In 1947, co-ordinating firms' annual plans for production, distribution, investment, imports and exports became its priority. The various "modernisation commissions" served as permanent places for dialogue among the administration and its "social" (business and labour) partners, and were institutions key to French growth until the 1960s. Claude Gruson, former director of the *INSEE*, claimed they constituted "one of the most important structural changes that marked this period", and further confirmed that the *Comités d'organisation* of the Vichy period "facilitated this transformation" as well.

Box III.2. The Planning Commission

The positive externalities associated with this institution in France during the *Trente Glorieuses* may, as Bertero (1997) stressed, be of particular interest for developing countries and countries in transition. Central in generating these externalities were: *i*) the interface between policy makers and the private economic and financial actors invited to take part in drawing up five-year indicative "plans"; *ii*) data collection on the real economy and the construction of statistical indicators to inform and evaluate policies; and *iii*) an independent research centre at the heart of the public debate, solely concerned with growth and the co-ordination of actors over the medium and long term.

One can of course admire the econometric achievements of the successive models used by the Plan [e.g. 1 600 equations integrating 4 000 exogenous parameters in the "Fifi" (physical-financial) model of the Sixth Plan (1970-1975)], but these were not responsible for the Plan's success. If the Plan became an institution central to French growth, it was not so much due to the quality of its forecasts or its theoretical role of direct co-ordination of economic agents (Hall, 1986), but to its key contribution to the *co-ordination of growth forecasts* and to the creation of a *climate of confidence* favourable to investment.

From this observation, one can assess the Plan's two primary functions as: *i*) forming a single arena or place for meeting and negotiating, a place "*of confrontation between partners pursuing specific interests*" within each sector (Malinvaud); and *ii*) giving economic agents a common outlook of reasonable growth projections, thus reducing public uncertainty. In 1967, a survey showed that 80 per cent of businesses knew the Plan's objectives and two-thirds of businesses knew its forecasts for their branch.

In brief, the Plan has not performed its mission through its "formal" functions but much more through the less visible process of preventing social conflict by helping social actors to learn experiment and accept social change, thus facilitating social change itself (see Hall, 1986).

2) *Nationalisations*: At the end of the war, General de Gaulle proclaimed: “The great sources of common wealth ought to be nationalised and no longer run for the profit of a few, but for the benefit of all.” The 1946 Constitution similarly proclaimed: “Every asset or company whose operation has or acquires the character of a national public service or of a *de facto* monopoly should become collective property”. The first nationalisations were *punitive* (for collaborating) and affected Renault, *Gnôme et Rhône* (the future SNECMA, producer of airplane engines) and the coal mines. In 1946 came the first wave of *strategic* nationalisations, with nationalised companies being placed under strict state control and 100 per cent ownership. Aimed at securing both supply and economic growth, the companies nationalised included the *Banque de France*, the four leading savings banks (*Crédit Lyonnais*, *Société Générale*, *Banque Nationale du Commerce et de l’Industrie*, and the *Comptoir National d’Escompte de Paris*), the 34 largest insurance companies, and almost the entire energy sector. The final wave in 1948 affected companies already under *de facto* state control: Air France and the company managing Paris’s public transport system (RATP).

While nationalised companies officially benefited from a degree of management autonomy, in practice they faced major constraints: public service requirements, local or regional development objectives, designated markets and suppliers, controlled prices, controlled access to financing, employee status similar to that of civil servants which limited managers’ discretionary powers to hire and fire, etc. State-owned companies would be more and more massively subsidised to cover their operating deficits. Their move towards greater autonomy and efforts to balance their budgets only began with the Nora Report in 1967. From the 1950s to the 1970s, the nationalised portion of the economy represented between 12 and 15 per cent of GDP – figures that nevertheless hide an indirect influence on the economy in the form of financial investments made by the nationalised sector. Between 1959 and 1972, these investments grew at twice the rate of the sector’s industrial assets (Gresh, 1975). The shareholder-state thus found an indirect way of supplying the economy with finance.

3) The creation of works councils (*comités d’entreprise*) was made obligatory for companies with more than 100 employees (a level later reduced to 50). These councils gave employees both the right to monitor corporate management on the board of directors, and the means to fund community services reserved for them and their families. These organisations greatly contributed to the rapid rise in the influence of workers’ unions, particularly in public-sector companies. The latter were expected to serve as industrial-

relations “showcases” (e.g. since 1945, the *comité d'entreprise* of EDF, the national electricity and gas company, has absorbed 1 per cent of the company’s annual sales, equivalent to about €400 million today). But from a broader national economic perspective, the “governance” potential of works councils has largely been neglected by both employers and trade unions, who have tended to emphasise the importance of their “service-delivery” activities. This emphasis has probably been due to the fact that unions were at the same time politically divided and ideologically opposed to a “co-determination” approach to collaboration with management. This situation has not changed since.

4) Finally, the national system of Social Security, a keystone of the welfare state, was organised to give elected representatives of employers and workers (referred to as the “social partners”) the task of managing the various benefit-funds (pension, family, health) open to employees. In practice, and unlike the German model, this “co-determination” never functioned on its own; on the contrary, it has always relied on the state, both in setting the framework for negotiations and in reconciling conflicts of interests.

Together, the measures adopted at the end of the war set out a coherent set of means through which the state fully controlled the circulation of savings to feed the budget (see Box III.3). From 1947, banks were obliged to seek the authorisation of the *Banque de France* before awarding large loans. Banking activity was further supervised by the *Conseil National du Crédit* (National Credit Council) and the central office for monitoring banking risk. Several procedures first laid out in the context of the war economy were reactivated and reinforced by the Ministry of Finance to provide the state with policy tools. These included the control of interest rates, access to the bond market, international currency exchange, prices (punctuated by a few periods of liberalisation) and credit supervision comprising ceilings on banking refinance, qualitative selection of loans and nationalisation of the largest banks.

Box III.3. The Treasury

From 1945, this flagship of the Ministry of Finance, which recruited the most brilliant young civil servants, reigned over the French economy. It was a symbol of the shareholder state and the banker state, which, “with its galaxy of financial institutions, structured an economy reliant on publicly administered finance” (Cohen, 1996). In addition to the administration’s traditional prerogatives (moving funds within the public sphere) it was designed to be “the inventor and chief orchestrator of the economy’s finance policy”. Among its responsibilities were credit policy, monetary policy (the *Banque de France* followed its instructions and ran the printing press according to the economy’s needs, feeding it either directly via advances to the Treasury or indirectly via the rediscounting of bank loans), shareholder of public enterprises, and market regulator. It would “bring into its orbit all of the French economy’s financial circuits and forcefully homogenise the financial community by making a gift of its brilliant servants to all parts of the financial community” (*ibid.*). The central mechanism (called “the Treasury Circuit”) was the large banks’ obligation to subscribe to the bonds issued by the Treasury. The money raised was ploughed back into the economy via the budgets of various ministries.

Through its instructions, investments and personnel the Treasury thus brought into its orbit of control all the suppliers of credit:

- Those specialised in medium- and long-term credit, the modernisation and equipment fund (*FME*), which became the economic and social development funds (*FDES*), and funds ranging from those for companies in difficulty (*Ciri*) to innovative companies (*Codis*).
- Those distributing soft loans (at very low interest rates) to finance exports (*Coface*), investment (*Crédit National*), construction (*Crédit Foncier*), and agriculture (*Crédit Agricole*) — which together became the leading source of long-term capital for corporations in the mid-1950s.
- Nationalised banks collecting national savings and, faithful to their tradition, only offering short-term financing services to companies via discounting of commercial bills.
- All private banks, whose management and loan decisions are framed by tight administrative control.

This formidable regulating power of the state enabled companies to access the long-term capital they needed for investments. Senior civil servants were convinced that the state should retain the upper hand in the huge investment effort necessary for economic “take-off”. It was thus that the state furnished 50 per cent of credits to the national economy and guaranteed 80 per cent of investment finance between the end of the war and the start of the 1960s (Boisvion, 1986). In 1980 (before Mitterrand’s second wave of nationalisation), over 70 per cent of national lending was still under the control of the public sector (Hall, 1986). This represented a major transformation in the way the investments of France’s largest companies were financed. Until this point, they had relied either on self-financing or (during the boom years in the decades of the 1900s and 1920s) on securities markets, without having recourse to either public funding or banks.

The First Plan (1946-1953) prioritised potential “bottleneck” sectors in which the beneficial knock-on effects for the rest of the economy were predicted to be the strongest: electricity, coal, steel, cement, domestic transport and agricultural machinery. These were first supplied via the *FME*, then the *FDES*, and then increasingly, from the 1950s, by medium-term credits from commercial banks discountable by the *Banque de France*. There was thus a movement from complete and direct state financing to intermediated financing, which did not, however, leave banks autonomous in their credit policies. Operationally, policies were enforced either by direct state control (nationalised companies), or via strong professional control over the chief sectors receiving credit. In this way, the corporatist inclinations of France’s economy were strengthened through access to resources.

Whether via its bodies for forecasting, management and surveillance, its use of price and salary controls, its control of the financial, energy and transport sectors, its expansionary fiscal and budgetary policies (the state was often the first client of major companies), or its research policies¹¹, the state thus became omnipresent in a period of 20 years.

Governance Focal Monopoly and Governance Culture

1) Create a governance culture in which private interests have to turn to the state

Several factors came together in 1945 that were favourable to making interests converge around the state. First, the French people, scarred by a long crisis that they largely attributed to political inconsistencies and the selfishness

of private interests that obscured the greater interest of the nation, believed that a strong state responsible for the national interest could avoid a repetition of the same mistakes. The institutional framework that emerged reflected this perception. The state became the principal actor in the French economy, centralising demands, allocating resources and regulating society. All eyes converged on the state, and expected it to forget no one. It was the unavoidable and uncontested artisan of all social and economic compromises. It promoted industrial growth, supplied financing, set quantities and prices (interest rates, salaries and goods prices) and provided the framework for bargaining among social partners. Until the 1970s, in sum, both company profits and the power of trade unions depended entirely upon public decisions.

As noticed by Rosanvallon (1990), the state's powers of motivation were not simply based on its power to regulate. They were much more the result of *i)* a capacity to exert widespread financial pressure; and *ii)* a strategy of multiplication of restrictive regulations; that *iii)* rendered firms dependent on the goodwill of policy makers to be granted funds or exemptions from regulations. Two examples illustrate. A firm would get an exemption from price control if it complied with "national" industrial objectives; the agreement could be materialised in an individual contract signed with the state. This tool, widely used in the 1960s, was all the more powerful because inflation was high. Granting tax exemptions was another option: all firms exporting more than 20 per cent of their sales were granted depreciation allowances after 1958.

The state had an arsenal of tools at its disposal that was unmatched in the Western world. With these, it was natural that unions, businesses and other interest groups (some of whose roots in French society predated the Republic's birth) developed the habit of looking to the state administration or its elected representatives to seek advantages and protections — and during this period of strong growth, they often won their cases. Indeed, what better way was there of consolidating one's own power than to lean on an omnipotent state? And what better way for the state to consolidate its power than to enact popular rules and then offer positive incentives in the form of exemptions (rather than inflict penalties) to selected firms?

Actual practices were thus not exactly as "participative" and "transparent" as in Monnet's prescriptions. The Plan did of course draw a variety of actors into the policy-making process at the beginning. But as planning became more complex and concerned all sectors of the economy, full citizen participation raised collective-action problems.

Modernisation implied strengthening the potentially most competitive sectors and letting the less efficient die, which would inevitably generate social dislocation and resistance: “Revealing the overall economic strategy encouraged those who would lose from it to begin protests at an early stage of the deliberations. [...] Therefore while the number of participants in the formal deliberations of the Plan increased dramatically from 1946 to 1970, the locus of power within the planning process shifted to a set of private discussions between state officials and small groups of enterprise managers. [...] In order to minimise social conflict and facilitate coordination, the real purpose of the Plan became to narrow the choices being actively considered by *i*) constructing a specific symbolic representation of the medium-term constraints which could not be ignored without risk; *ii*) masking individual loss with the veneer of common interest; *iii*) presenting industrial execution as economic euthanasia; and *iv*) tying present sacrifice to future gain. Planning involved the production of norms to prevent social conflict more than the delineation of choices” (Hall, 1986).

State-business co-operation has thus in fact largely been operating among the most powerful factions on both sides. In the 1950s, it still involved trade associations and professional groupings; yet policy makers started to bypass them to negotiate directly with managers when they systematically opposed change. In the 1960s, the co-operation involved a limited number of big firms’ managers, high-level civil servants and political decision makers intending to reach effective bilateral agreements negotiated behind closed doors. To a large extent, state policies favouring “great projects” and “national champions” created powerful new actors with whom the state itself would ally.

It is significant that workers’ unions were not part of this process. Two of the largest unions – CGT (*Confédération Générale du Travail*) and FO (*Force Ouvrière*) – had withdrawn from the Plan’s negotiations as early as the preparation of the Second Plan (1953). The low rate of unionisation in the 1960s (around 15-20 per cent) combined with the strong political divisions among them rendered them poorly representative and politically quite inefficient. Increasingly, their political bargaining power diminished, especially in comparison with that of big business managers.

2) Stabilise power and homogenise elites’ interests

Two phenomena strongly contributed to institutionalising this new governance culture, based on the focal position of public institutions, while at the same time consolidating a considerable concentration of power and resources (capital and knowledge above all) in the hands of a small elite.

One was the remarkable political stability of the country after 1958: de Gaulle remained in power for ten years, and the Right remained for 23 years. As the person who “saved” France twice (in 1940 and in 1958), de Gaulle had enormous legitimacy. Moreover, the constitution of the Fifth Republic enabled him to concentrate most executive power in his hands: directly elected by popular vote as President, he was also the leader of the parliamentary majority (the legislative power). Under the auspices of the *Chancellerie* (Ministry of Justice), the judiciary was kept under the control of the executive as well (and was therefore not a veritable independent “power”). Finally, as regards the dissemination of news and information, the creation of the *ORTF* in 1964 established a state monopoly in television and radio.

The other was the elite training and placement system. As many have observed, “One of the principal elements of the symbiosis between a state receptive to the arguments of oligopolistic industries, and large companies with the reflex to request public support, was the system of producing elites via the famous *Grandes Écoles* — in particular the *École Nationale d’Administration* (ENA) and the *École Polytechnique*” (Chesnais, 1993). The most typical characteristic of French economic elites is that they began their career in the public sector. Also important in the small number of key French institutions of corporate governance is the practice of moving from public administration to the private sector (“*pantouflage*”), a result of the state’s traditional monopoly on higher-level education via the system of the *Grandes Écoles*. The latter comprised several schools, each with an area of specialisation, including administration (the ENA was created in 1945 to train high-level public administrators) and engineering (*Polytechnique, Les Mines, Centrale, Les Ponts*, etc., all dating from the 18th and 19th centuries). Through highly competitive entrance examinations, the *Grandes Écoles* recruited the best students from a given age group who upon graduation were integrated into one of the public-sector “corps” (each of which traditionally designated a specific occupation, but today has little more than corporatist significance). Graduates were obliged to devote at least ten years of their professional life to the state.

More generally, in fact, whether top managers were in the public or the private sector (the latter included the leading entrepreneurial families — e.g. Peugeot, Michelin, Mulliez, Rothschild, Taittinger, de Wendel), the networks of their personal relationships, the monarchical structure of their companies’ internal governance institutions (hierarchically compartmentalised systems of negotiation, deliberation and decision making) and their recruitment policies all served to reinforce and consolidate the group’s decision-making power at the national level (see among others, Bauer and Cohen (1981), Bourdieu (1989) and Garrigues (2002)).

Recruitment was based heavily on co-optation, “*pantouflage*” and solidarity among “comrades” who graduated from the same schools or belonged to the same “*grands corps*” of the public sector and were capable of monopolising access to management functions in entire sections of the state administration and the economy. Examples include the *corps des Mines* (Mining) and that of the *Ponts et Chaussées* (Technical Engineering) in industry, the *Inspection des Finances* or the Treasury in banking and insurance, etc. In 1954, 4 per cent of the heads of *private* banks came from the public service; in 1974, the number had risen to 30 per cent, and 43 per cent for the heads of the 100 largest French groups (Birnbaum, 1977; Birnbaum *et al.*, 1978). The circuits of power, information and resources were organised by and restricted to an elite, united by a network of common interests that was both articulated and assured by the state. The relationship between political governance and corporate governance was all the more effective for being symbiotic, intrinsic to the system of elite education.

3) Governance by a public focal monopoly

In the manifest absence of countervailing powers or credible checks and balances, how could this highly relationship-based and non-transparent governance system function effectively? The oligopolistic configuration of private power could have led to open conflict among the most powerful interest groups, each seeking to gain or preserve a maximum share of rents to be generated. As Olson (1982) and Oman *et al.* (2003) explain, such situations of tension among members of an oligopoly tend to generate excessive rigidity and resistance to needed change, accompanied by sudden periods of excessive volatility, rather than gradual yet continuous change, with the outcome often being one of wealth destruction and a hindrance to overall growth. The societal gain emerging from these rivalries is limited, often negative (owing to significant waste of resources consumed by inter-factional competition), as the costs borne by many emerging and developing countries plagued by this type of internal struggle attest (Oman, 2003).

How — and to what degree — did France succeed in avoiding this scenario? The evidence suggests that the oligopolistic concentration of economic and political power in this country came to be reinforced by a hierarchy strong enough to give an effectively *monopolistic* character to its structure and behaviour. The institutionalisation of this structure began during the Second World War and reached a peak around the mid-1960s.

The strength of this type of governance system is that it can function *as if it were* a monopoly, with the state at its centre and the country's actors coordinating themselves around it. The system was made possible by the role of governance *focal point* assumed by the institutions that emerged in the public sphere. The functional link between the state and society could be assured by a given administration, ministry, commission, general prefect, member of parliament or mayor — any of which constituted a potential focal point for crystallising social expectations, in that they all projected the virtually mythic guardian figure of the state¹². These institutions jointly induced an effective coherence among private actions that served the broader collective interest.

We can baptise the phenomenon — or at least the ideal-type to which it refers — a *public governance focal monopoly*. To be clear, this term does not refer to a public monopoly over governance, nor to a focal monopoly over only *public* governance, but to a public monopoly over the focalisation of governance relationships.

This concept or “model” of governance goes beyond such much-studied features of state behaviour as interventionism, dirigisme, planning or centralisation, because understanding the functional qualities of a system of governance — certainly in the age of corporate capitalism — explicitly requires a grasp of the functioning of both political *and* corporate-governance institutions, and potentially of all governance systems, in a given society. This comprehensiveness is what the concept of governance *culture*, by definition, refers to.

Annex 2 illustrates and formalises the definition of “governance culture” and the social utility of the governance focal monopoly using game theory.

Confidence, Growth and the Governance Focal Monopoly

“Good corporate governance goes beyond common sense. It is a key part of the contract that underpins economic growth in a market economy and public faith in that system.” Witherell (2002) may state the obvious, but this fact has nevertheless long been ignored. Since the scandals recorded in the United States, a country “which, on paper, had one of the best governance systems” (*ibid.*), the following simple sequence has been revealed several times (not accounting for possible feedback effects):

“Bad” institutions or practices of corporate governance are sufficient to cause a loss of confidence, which in turn may cause a slowdown of growth.

But Witherell (2002) goes beyond this proposition, largely accepted today, in suggesting the existence of an inverse and virtuous circle, which could be described as:

“Good” institutions and practices of corporate governance are necessary for confidence, which is in turn necessary for growth.

While this might seem to be disconcertingly simple, it is not. How else to explain — given the size of the stakes — why awareness came so slowly? The delay seems to be the result of a double negligence, or a double incapacity. The first concerns the lack of a precise definition of what is meant by “good” or “bad” institutions and/or practices of corporate governance: people have often spoken of them without having any robust empirical confirmation of their existence (although such a definition is often implicitly presumed). The second concerns the role attributed to *confidence* in growth mechanisms, and its links with governance institutions: while most people intuitively perceive the importance of confidence, or trust, and its “social virtues”, the fact that it is difficult to quantify and insert into equations means that the power of economic theory is greatly diminished in the face of “the confidence issue” (Fukuyama, 1996; Peyrefitte, 1998).

Witherell (2002) raises two issues in this regard. First, he highlights the criterion of *efficacy* to evaluate institutions and practices of corporate governance. Second, he expands the concept of confidence (traditionally restricted to those actors strictly involved in the central agency relationship of corporate governance, i.e. the relationship between managers and shareholders) to that of broader *public* confidence. It is indeed true that the potentially damaging consequence of cases of “abuse” of confidence in corporate-governance institutions makes the public directly concerned, since companies provide jobs, taxes, goods and services, as well as shares in which a significant part of national savings may be invested.

France’s public governance focal monopoly provides a perfect example of a governance mechanism in which confidence acts as a lever. It is possible to identify two main channels by which it affected growth.

1) Via Information, Transaction, and Enforcement Costs

According to North’s and Wallis’s (1986) estimations, transaction costs broadly defined can account for almost half of a country’s GDP. Reducing them thus offers an extraordinary way of acting on growth. Greater levels of

“*trust capital*” among partners will lower the costs related to information search, contract specification and monitoring contract fulfilment, and facilitate cooperative relationships. The value of this collective asset formally corresponds to the sum of reductions in risk premiums demanded by partners, compared to a situation wherein confidence is absent (Breton and Wintrobe, 1982).

France’s system of education, recruitment and self-regulation of elites provides a good illustration. In addition to ensuring that leaders obtained a high level of education, it considerably reduced both the occurrence and the costs of resolving conflicts among them by nurturing a shared culture throughout their school years, and reinforcing it with their membership in the same networks. The majority of the French elite were linked by ties of friendship, or of more or less reciprocal esteem and loyalty. As co-ordination between elites was facilitated, so too was policy implementation, which in the 1960s translated into the execution of large investment projects. “The industries which have experienced the greatest expansion are also the industries in which the state has shown the greatest interest. These are also the industries in which the members of the *Grands Corps* are to be found in the directorial posts” (Warnecke and Suleiman, 1975).

Another advantage was a reduction of asymmetries and information costs. The practice of *pantouflage* enabled the major business professions to develop a deep understanding of the public sector. Conversely, the restructurings of the 1950s and 1960s, which entailed massive preparatory work by each sector’s regulatory administration, provided these administrations with an opportunity to reinforce their expertise and intervention capabilities. This they did either directly by influencing policy formation (subsidies, taxes, etc) or less visibly, but possibly even more securely, via the actual management of businesses through transfers of senior civil servants. *Pantouflage* is an excellent example of an institution (a “rule of the game”) that by its very nature is simultaneously economic, social and political. Through the custom of meeting (and evaluating) each other informally and continuously, all the key elements of the governance culture (in this case, the rules of the game of the public governance focal monopoly) were immediately common knowledge. This gave public and private elites an invaluable low-cost capability to co-ordinate.

The convergence of interests organised by the power of the public governance focal monopoly restricted the use of more formal prudential rules and control procedures. Risks were limited by the low importance of mechanisms situated outside the focal monopoly’s sphere of influence. The “Treasury Circuit” functioned in precisely this way (Perrut, 1998); the framing

of credit allowed banks to choose those borrowers that presented the least risk; growth occurred at low levels of risk, thus at low costs (zero or negative real interest rates) and was guaranteed because borrowers knew that the state, being at the system's centre, would not want to destabilise it. And indebtedness, limited by the narrowness of markets, was not used to fuel speculation. Banking margins were low, but assured. All this was common knowledge among the elites, so all trusted the regulations coming down from "on high" and all had a vested interest in perpetuating a governance system that guaranteed the stability of their rents.

2) Via Expectations

Every investment, savings or financing decision is composed of a forecasting dimension and an inter-temporal choice. Forecasts have two basic characteristics: first, they are forward looking; second, they are potentially self-fulfilling (Plihon, 2000). The result of the first characteristic is that every forecast has an impact on the present. It is thus essential for an actor laying the groundwork for a decision to possess as clear an assessment of the development outlook as possible. If the forecast is thoroughly credible, the second characteristic means that it has a strong possibility of coming true. We know that a depressive mindset of entrepreneurs itself is a factor in reducing investment. In contrast, the role of mobilisation and co-ordination played by public institutions throughout the *Trente Glorieuses* in giving entrepreneurs optimistic and believable signals (Plan objectives, public finance, social stability, the Common Market, etc.) permitted their expectations to focus on a high growth equilibrium, thus encouraging entrepreneurs to bet on strong growth in their investment decisions and, thereby, contribute to the attainment of those optimistic growth expectations. Starting from the launch of the Second Plan (1954), the effect of reducing uncertainty is clearly distinguishable in corporate debt and investment decisions (and thus, in sum, on growth itself via the intermediaries of salaries and household consumption).

As to workers' anticipations, the macroeconomic analysis of Bénassy *et al.* (1979) helps clarify their role by setting the wage-bargaining procedures at centre stage. New labour legislation passed in the late 1940s, the establishment of a minimum salary in 1950 (whose level would be subject to permanent bargaining among social partners), and the existence of a collective framework (instead of a firm-level basis) for negotiation between the social partners led productivity growth to be integrated *ex ante* into nominal salaries (instead of benefiting workers only *ex post* through the reduction or slower increase of

prices). Resulting from these institutional innovations, from 1958 onwards, real wages tended permanently to increase, especially when all social allowances are considered. Confident that this process would go on (since it was embedded in institutions), workers contributed to the realisation of optimistic growth expectations through their high levels of consumption, which producers anticipated in their investment programmes, demand for funds, etc.

The same kind of dynamics worked for the majority of social and economic sub-systems: the state organised the convergence of interests, acted as a producer-guarantor of optimistic expectations for growth and well-being, and guaranteed the stability of the governance system. It was the great insurer or lender of last resort, in social relations as in the financial system: costs would always be shared. Knowing this (common knowledge, again) entrepreneurs – individuals and organisations – all had an interest in co-operating, and thus contributed by their actions to the self-fulfilment of the optimistic expectations, attainable only through widespread co-ordination (see Annex 2).

Is Efficiency the Principle of Institutional Selection?

Saying that the focal monopoly reduces information and transaction costs, and helps society to control opportunistic behaviour or to select Pareto optimal equilibria (see Annex 2), does *not* amount to saying that any of these functional criteria is sufficient to explain which institutions prevail. As North (1990) underlines, the institutions that prevail in a given society do not generally prevail because they are relatively efficient. For Aglietta (1976) and Boyer (2003), they emerge from social conflicts that find expression in politics and may eventually be reflected in law.

The next period of France's history (the subject of Chapter IV) as well as evidence taken from the experience of many developing countries (presented in Chapter V) confirm that different types of institutional "failures" and institutional "traps" often prolong the existence of institutions that are economically highly *inefficient* for society as a whole.

Conclusion

Similar to the findings of case studies of corporate governance in several developing and emerging-market economies carried out by the Development Centre (Oman, 2003), analysis of France's growth during the *Trente Glorieuses*

shows the extent to which one cannot understand a country's institutions of corporate governance outside their interaction with their socio-political environment and, especially, with the country's institutions of political governance. The fact that banking and industrial capitalisms were embedded in the state, allowing the latter to enhance the efficacy of its industrial, economic and financial policies, implies that our understanding of the institutions and practices of corporate governance cannot be separated from our understanding of those of the state.

Second, the most remarkable effect of the governance culture analysed in this chapter is the construction and perpetuation of a "climate of confidence" favourable to growth by reducing both transaction and uncertainty costs. On the basis of France's experience during the *Trente Glorieuses*, we are finally able to characterise "good" institutions of governance in general, and of corporate governance in particular. They are institutions that are *capable of preserving "public confidence" over the long term*, i.e. capable of anticipating and addressing factors that potentially (highly) threaten collective confidence. Together these factors delineate the ground of what one could call the "governance risk". Preventing this risk (i.e. identifying, evaluating and acting on risk factors) is the basic mission of corporate-governance institutions. Differing from one country, sector and company to another, the form and content these institutions should be given are necessarily functions in part of the specific country, sector and enterprise.

Third, public confidence will not increase in the long run unless the institutional arrangements put in place benefit both individuals and society as a whole. This is precisely one of the principal sources of long-term growth identified by North after he demonstrated that the explanatory variables of traditional theories (such as the accumulation of capital, technology, and economies of scale) are more indicators and manifestations than determinants of growth. The causes of growth should be sought in the existence "of (implicit and explicit) incentives for efficient organisation". Inversely, inefficient institutional arrangements (furnishing few incentives for efficient organisation) and inequitable ones (benefiting, for example, certain individuals more than the whole of society) are not likely to be sustainable, and deter public confidence more suddenly.

Fourth, thanks to a strong political will to orient all social forces in the same direction and towards the same goal, the institutions sustaining France's governance focal monopoly functioned long and well enough to generate beneficial effects, by avoiding the negative-sum games typical of rivalry among oligopolistic interest groups. This does not mean that these interest groups

failed to put down roots; it is just that in order to preserve their advantages at the least cost, it was in their interest to accept the practical requirements of the focal monopoly (see Annex 2).

However, if France's governance culture enabled a high level of economic efficiency to be attained during the *Trente Glorieuses*, it was also because at least two additional institutional conditions were met during this period: *i*) a low degree of economic and social openness, both internationally and in terms of independent market ("free-market") mechanisms domestically; and *ii*) the political elites' full respect of democracy's golden rule: that the governed can change those who govern through the ballot box.

Regarding the first point, once the rules of the game were substantially changed, it was foreseeable that dysfunctions in the system would emerge. These dysfunctions could be caused by greater opening (regional integration, globalisation) and/or by the accumulation of internal imbalances (long concentrated in the inflationist tensions in the product markets and resulting in repeated competitive devaluations until the end of the 1960s). The concept of a governance focal monopoly suggests that individualist and divergent strategies with high social costs (of the prisoners' dilemma type) could resurge among elites as soon as the governance focal monopoly lost its force of attraction, with confidence in its regulatory power (and thus its effectiveness) diminishing accordingly.

Concerning the second point, contrary to what some suspected in 1945 and in 1958, de Gaulle did not seek to exploit the political apparatus for his personal profit by transforming himself into a president for life. Instead, he sought massive public support. More than any of his successors, de Gaulle also used electoral referenda, and was determined to resign on each vote should the results be unfavourable. In this sense, the regime was not without checks and balances since its head was ready to submit himself to the highest form of democratic check and balance. By this ambiguous posture (of wanting to govern a true democracy, but in a state of permanent plebiscite), de Gaulle enabled French democracy to find a viable equilibrium, combining the efficiency of a strong executive with the principle of accountability of the elites. This balance was close to the optimum described by Olson (1993): "Sustained economic development may require governments that are strong enough to last indefinitely, yet so limited and restrained that they do not use their overwhelming power to abrogate individual rights."¹³

Notes

1. Similar fates were foreseen during this same period for many independent developing countries, notably in Latin America. "Export pessimism" encouraged many to adopt or persevere in policies of import substitution aimed (often unsuccessfully) at reducing their dependence on exports (Oman and Wignaraja, 1991).
2. Transatlantic productivity study tours were a central part of the highly successful technical assistance programme of the Marshall Plan. They brought an estimated 24 000 Europeans to the United States "to see at first hand the manifold requirements of a competitive operational plant...new concepts of organization of the workplace, new concepts of marketing and business organization, new products, new design and engineering functions, and new equipment" (World Bank, 1992).
3. The 1940 law was innovative in corporate-governance terms in its provision for the creation of "committees" composed of sub-groups of directors and executives charged with addressing specific sets of governance issues. Here again, it would be 50 years before the notion of committees created by the board of directors would become an undisputable element of "good governance".
4. The automobile sector was an exception. The least competitive firms disappeared without major distortions to the competitive structure: 155 manufacturers in 1924, 60 in 1932, and 31 in 1939. In 1951, the four leading manufacturers (Renault, Citroën, Peugeot and Simca, a Fiat subsidiary) controlled almost 90 per cent of the market (Caron, 1995).
5. Once central authority was re-established (1944-45), de Gaulle put forward a constitutional plan based on a strong executive. Because the weakness of the parliamentary regime of the Third Republic had made the government unstable, de Gaulle opted against proposing such a regime. Opposed by the Socialists and Communists, who worried that the General-President might drift into authoritarianism, de Gaulle quit France's provisional government in January 1946, which led to the creation of the Fourth Republic. Confirming de Gaulle's forecasts, this Republic would be marked by permanently alternating governments caused by fluctuations in power relations in the National Assembly. In 1958, incapable of resolving the "Algerian Crisis" (Algeria's War of Independence), the

government was threatened by a coup d'état. The French population demanded that General de Gaulle return. He accepted on condition that a new constitution be passed on referendum. Still in place today, this constitution inaugurated the presidential regime of the Fifth Republic, characterised by a strong concentration of power in the executive. (In de Gaulle's view, the President, who is elected by direct popular vote, and the Government, i.e. parliamentary majority, should logically come from the same electoral majority; in 1986, for the first time, this did not happen, and France experienced its first period of "cohabitation" involving a President and Government of opposing political majorities.)

6. See the chapter on Brazil in Oman (2003).
7. Europe began with the European Coal and Steel Community (ECSC), instituted in 1951 to create a first common market for strategic materials. In 1957, the European Economic Community (EEC) was born with the Treaty of Rome. This "Common Market" initially included Belgium, France, Germany, Italy, Luxembourg and the Netherlands. Its objective was partly to create a customs union ensuring free circulation of goods, and partly to put in place common economic and financial policies. It is very likely that the French signatories of the Treaty of Rome were conscious that the agreement would entail an obligation for the French economy to adapt. The evolution was indeed spectacular: though initially foreign trade was largely composed of consumer, agricultural and intermediary products, and aimed at the captive markets of former colonies in the 1950s (in 1952, 42 per cent of France's exports went to countries in the Franc zone in Africa; 16 per cent to other EEC countries), exports very quickly reoriented towards capital goods destined for the Common Market (50 per cent of exports in 1970, and 10 per cent for the Franc zone). Having been the highest in Western Europe until 1962, customs tariffs were essentially dismantled by 1970. In order to understand the hierarchy of political objectives and the magnitude of economic transformations accomplished in such a short period of time, one must highlight the driving force that Europe represented (particularly the planned opening of borders).
8. A good example is the railways, which almost unavoidably fell into the public domain. Subject to substantial investment costs on one hand and to fares imposed by the state on the other, the companies operating the various lines since the mid-19th century never really flourished. By a convention signed in 1921, the various networks put in place a mechanism to restore financial balance automatically if one of the networks fell into deficit. This solidarity was not sufficient to compensate for the losses during the 1930s, however, and since the traditional holders of equity in the railways either could not or would not invest more, the state had to cover the losses. It thus found itself with 51 per cent of shares at the head of the SNCF (the French National Railway Company), created in 1937, and merged several networks into one sole network under its responsibility.
9. Founded by Napoleon Bonaparte in 1800, the *Banque de France* was all-powerful until it was nationalised in 1936. It was feared by governments, having several times imposed its decisions on them (for example by refusing to support Gambetta

in 1870 at the height of the Franco-Prussian War). Its board of directors (the *Conseil des Régents*) was appointed by the 200 leading shareholders in the Bank. Given the prohibitive price of its shares, these shareholders roughly corresponded to the country's 200 wealthiest individuals and organisations — a figure that gave birth to the myth of the “200” in the 1930s, as popular as that of the “Wall of Money” against which the Left was shattered in 1924. The nationalisation of the *Banque de France* in 1936 enabled the government to control its operations, also allowing the Minister of Finance, Vincent Auriol, to savour the Left's historic revenge: “the banks, we lock; the bankers, we lock up!” (Milési, 1990).

10. Must one see in this a complete reversal of the ideals that motivated French elites? Bloch-Lainé, himself a high-level civil servant, explains this phenomenon as more a matter of prudence: “One must understand to what simple prudence can lead (prudence always having been one of the essential principles of the bourgeoisie both in the upper echelons of the civil service and in business). In 1940 and 1941, very few doubted a German victory. Prudence at that time consisted of surviving without taking risks. In 1944, prudence consisted of investing in a different future by purchasing oneself a late badge of resistance” (Bloch-Lainé and Gruson, 1996).
11. Many R&D organisations were created in the 1930s and 1940s (including the *Caisse Nationale de la Recherche Scientifique* in 1935, later to become the *CNRS*). From the 1950s, the state co-ordinated and stimulated research, such as the 1950s “action programmes” (e.g. in steel) followed by the “great programmes” of the 1960s, which served as well to promote the development of private research (e.g. in atomic energy, arms, telecommunications, electronics, aeronautical and space industries). The true awakening to the importance of R&D dates from the 1960s. Public financing funded 68 per cent of French research in 1968. In 10 years, the share of R&D spending in the state budget increased from 2.5 in 1958 to 6.2 per cent in 1967. Total R&D expenditure as a percentage of GDP doubled from 1.1 in 1959 to 2.2 in 1967.
12. See Legendre (1976, 1999) for a legal and anthropological analysis of the state in France.
13. Olson (1993) follows by showing how a regime in which uncertainty exists regarding continuity and respect of individual rights is harmful to long-term growth, precisely via anticipations and confidence: “Some dictatorships have, at times, provided individuals with the rights needed for competitive markets and thereby brought about periods of rapid economic growth. Yet the dictators' subjects have not only lacked political freedoms, but also any confidence that their property and contract rights will continue to be respected if the regime, or even the dictator's policy, changes. Thus the markets do not elicit as much investment and economic advance as would have occurred if everyone were confident that they would last. It is only in the stable, developed democracies that there is a widespread confidence that the individual rights needed for a thriving economy can be relied upon in the long run. These are the societies where property and contracts are the most predictable

Chapter IV

An Obsolete Governance Culture?

Summary

Why were the institutions that made successful the governance culture developed in France throughout the *Trente Glorieuses* not maintained?

By the 1970s, this governance culture appeared increasingly costly and ill-adapted. Under the combined forces of several factors (European integration, the growing importance of financial markets, liberation of economic actors, social crisis, decentralisation), the state's focal monopoly was threatened by competition and fragmentation. Its legitimacy crumbled. By losing some of its ability to polarise, the public governance focal system lost its effectiveness. It was therefore necessary to find new regulations. But both the uncertainty of the benefits of reforming the institutions of governance (due to the difficulty of assessing the nation's medium and long-term perspectives) and the power of the vested interests created by the governance culture of the *Trente Glorieuses* brought about strong resistance to institutional change, particularly from elites prompted to defend their threatened prerogatives.

Introduction

There were a number of necessary conditions for the governance focal monopoly of the *Trente Glorieuses* to be effective. The first two concerned the relative autonomy of the economy vis-à-vis, first, free-market mechanisms, and, second, external competition and regulations. This autonomy was called

increasingly into question by the accumulation of internal tensions within the economy and by advancing European integration, leading to the emergence of financial markets and Europe (with new goods and services markets, serious competition and independent regulatory institutions) as new focal points.

Transformation of Financing Structures

Rise of Financial Intermediation

At the start of the 1960s, corporate financial needs grew massively, owing both to greater profit-eroding international competition and the increased financing requirements generated by accelerated internationalisation and industrialisation (R&D, marketing, etc.). In the face of these expanded needs, public budget resources dried up. This double constraint forced the Gaullist administration to devise a complement to the Treasury Circuit, and to find ways of tapping more of the national savings.

A number of measures were first introduced between 1960 and 1965 to encourage both company savings (e.g. accelerated amortisation) and household savings (e.g. tax incentives for holding stocks, employee profit-sharing plans). A large scale reform aimed at relaxing the constraints on financial intermediaries and at invigorating household savings was implemented in 1966-67: the distinction between commercial and savings banks was softened, and obligatory rediscounts with the *Banque de France* were suppressed. Banking was liberalised so that individual bank branches could be opened freely. The financial system was made secure, and obligatory (non-remunerated) reserve requirements became the principal instrument of monetary policy (replacing the rediscount rate). The COB (*Commission des Opérations de Bourse* — Stock market Commission) was created to supervise transactions and inform investors.

These reforms achieved their aim. By the beginning of the 1980s, 93 per cent of French households had a bank account, as opposed to 30 per cent in 1965, and the gross household savings rate (gross savings/disposable income) increased from 10 per cent in the 1950s to 20 per cent in 1975. The lifting of banking specialisation sparked a major move towards integration: in 1973 six groups accounted for 80 per cent of all banking balances. At the start of the 1980s, France had the second largest network of bank branches in the world, after the United States. Banks learned to transform liquid household savings into long-term capital, thus taking over from the public or semi-public organs

at the heart of the national financial system. The Treasury's share in long-term investment credits plunged from 78 per cent in 1954 to 15 per cent in 1974. It was thus banks, rather than the administration, that had direct contact with borrowers and made the majority of credit decisions.

Indebtedness was likewise encouraged by the natural lightening of debts under the effects of inflation (regularly 10 per cent a year in the 1970s). As reflected in company reports (Table IV.1), France tipped into an "economy of indebtedness" in which the desired investment rate structurally exceeded the available savings rate, the difference being supplied by indebtedness. This adjustment in the financial system, in facilitating access to credit from the late 1960s, certainly contributed to supporting consumption and investment, and thus to conserving (temporarily) elevated growth rates: 3.2 per cent a year in 1972-77, against 2.2 per cent in Germany and 2.7 per cent in the United States.

Table IV.1. **Liability Structure of Listed Companies* (% of Total Liabilities)**

	1961	1969	1976
Shareholder Equity	45	33	25
Total Debt	55	67	75
Short term	43	52	56
Medium and long term	12	15	19

Note: * Excluding nationalised companies.

Source: Dubois (1978) and Caron (1995).

Beyond corporate finance, the entire French financial system rested on the banks. They acted as the relay between credit policy, monetary policy and the government's industrial policy (with the *Banque de France* as lender of last resort). The French economy in a sense constituted a more extreme version than Germany of a "bank-based system". It is also much closer to the financial systems characteristic of many developing countries, with the state at the summit of the banking hierarchy (whereas the German banking system operates largely independently of political power).

Imbalances Accumulate

The elevated inflation rates (although restrained to around 10 per cent) pushed savings towards property or liquid investments rather than longer-term investments in financial securities. The proportion of short- to long-

term investments between 1965 and 1980 was 80 to 20. The private securities markets were structurally thin, and the chief task of the financial system was to ensure the conversion of short-term savings into long-term resources available to companies.

This requirement was the source of two imbalances. First, certain specialised savings-collection networks that benefited from past privileges (the *Caisses d'épargne* savings and deposit banks, the non-profit "mutualist" savings organisations) found themselves with a strong surplus while the banking network was in chronic deficit. The partitioning of the financial system thus secured rents, on one hand, and led on the other to a multiplication of dispensatory mechanisms to compensate the non-privileged sectors for their competitive disadvantage. Second, contrary to investment financing through the sale of securities, financing via the transformation of savings did not make the saver's assets unavailable to him or her, and thus maintained inflationist pressures.

In brief, the nation's corporate-finance system was inflationist, costly, encouraged over-indebtedness and weakened the balance sheets of both companies and banks (shareholder equity represented 40 per cent of bank liabilities in 1967, and only 8 per cent in 1980). Furthermore, it was becoming extremely complex: in 1981 over 70 financing regimes with preferential rates co-existed, accounting for 44 per cent of credits in the economy. With the 1945 legislation covering only 40 per cent of banks, the rest were regulated by special schemes.

Major economic imbalances added to these financial imbalances in the 1970s: the planning of the growth of real wages (resulting from the negotiations that followed the social crisis of May 1968) and then the global rise in the price of raw materials (following the oil crisis of 1973), and a slowing of productivity growth, all converged to put firms' financial health in danger. Previously, in exchange for accepting a ceiling on their profits due to price controls and socially organised wage increases, major firms had been granted virtually unlimited access to credit finance. Yet the whole system could only function thanks to monetary "laxism" which allowed tensions to be absorbed in inflation, at the price of frequent "competitive" devaluations needed to compensate for the differential inflation rate with respect to competitors and to preserve international competitiveness.

But these arrangements reached their limits at the start of the 1980s. The appearance of positive real interest rates (due to the "austerity u-turn" of policy

under Mitterrand in 1983 and the subsequent policy of competitive disinflation¹⁾ put the already heavily indebted companies into great difficulty and rendered a reform of the whole financial systems unavoidable.

But how could the financial system be made more efficient without weakening the whole economy? To do so required finding ways: *i)* to avoid the transformation of short-term savings at the cost of profound imbalances; and *ii)* to stimulate the emergence of capital ready to engage for long periods in industrial ventures.

Setting-up Effective Capital Markets

It was the state itself (needing an efficient financial system in order to issue and sell its debt on financial markets), and as it happened a socialist government under Mitterrand's presidency (elected in 1981), that organised both this transformation and the state's withdrawal from the financial sphere beginning in 1983. In the first half of the 1980s, a battery of measures resulted in radical financial liberalisation — paradoxically facilitated by the nationalisation of the near totality of the country's financial institutions, which were thereby placed under the state's direct control.

As regards *banking*, these measures included: the abolition of specialisations, de-partitioning of networks, suppression of dispensatory privileges and procedures, authorisation in principle of universal banks, and establishment of a single legislation applicable to all lending institutions; the liberalisation of interest rates, the end of credit rationing, and reduced preferential lending rates. In 1986, a few banks were already ready for a first round of bank privatisations (under Mitterrand with Chirac as Prime Minister).

As regards the *market*, measures included: creating a unified capital market open to all agents (financial, non-financial, national, foreign); fiscal incentives and simplifications; diversified securities-offerings with the creation of negotiable debt-securities issued by banks, corporations and the state, and sold on money markets; creation of a "second market" with simplified rules and a minimum mandatory level of equity available for public trading reduced to 10 per cent, designed to facilitate small and medium-size enterprises' (SMEs') access to public savings; creation of derivatives markets, including a futures market (*MATIF*), an options market (*MONEP*) and a specialised market for firms with strong growth potential (new market). Only once all of these reforms were accomplished were foreign-exchange controls lifted (in 1989).

The *results* of this reform policy were as rapid as they were spectacular. From 1983, the share of long-term investment and liquid savings was rebalanced at a ratio of about 40 to 60. Between 1980 and 1990, share issues increased eight-fold, the volume of shares negotiated increased ten-fold and market capitalisation increased five-fold. Between 1980 and 1998, total market capitalisation (shares, bonds and other debt securities) exploded from 30 to 150 per cent of GDP.

Markets Explode in Corporate Balance Sheets

The share of *debt* in corporate liabilities fell by more than half between 1980 and 2000, from 64 to 28 per cent (Table IV.2). Commercial credit fell by the same proportion, reflecting a drop in the former system of cross-financing by payment facilities (in commercial transactions). Corporations' ability to *self-finance*², after falling from 80 per cent of investment in the 1950s and 1960s, to 70 per cent in 1970, then to 62 per cent in 1980, climbed to 75 per cent in 1985, 90 per cent in 1990 and 112 per cent in 1995.

Finally, *shares* doubled in company liabilities from 34 to 67 per cent between 1980 and 2000. In the banking sector's balance sheets, the share of financial securities (shares, bonds and other debt securities) exploded from 5 to 50 per cent of assets, while that of loans fell from 84 to 38 per cent, and that of deposits from 73 to 28 per cent of liabilities (Plihon, 2000). One must however remain cautious in interpreting the growing importance of shares in balance-sheet indebtedness. While in the 1980s this growth represented a balancing effect, in the course of the 1990s it was increasingly due to a speculative rise in share prices that contributed to an illusion of solidity in balance sheets (by artificially diminishing debt/capital ratios). Whatever its cause, the significant point is the emergence of financial markets, and the prices established on these markets, as a new focal point for economic actors. "The marketisation of finance is not so much the replacement of intermediated finance by direct finance as it is the increased dependence of all finance on market prices" (Aglietta, 2001).

A breakdown of the flow of external corporate financing according to whether or not it is via securities issues on the markets completes and confirms the results of this analysis: the share of market finance has progressed spectacularly, from one-quarter of external financing between 1978 and 1983 to more than three-quarters in 2000 (*Banque de France*, 2002)³.

Table IV.2. Evolution of French Corporate Balance Sheets (1980-2000)

Assets	1980	1990	2000
Real assets	52	45	43
French shares	8	15	19
Foreign shares	2	6	15
Credits and financial securities	6	13	12
Commercial credits	21	16	9
Treasury	10	6	3
<i>Total</i>	<i>100</i>	<i>100</i>	<i>100</i>
Liabilities	1980	1990	2000
Listed shares	5	10	21
Non-listed shares	29	41	46
Financial securities excluding shares	3	5	5
Debt to financial institutions	30	23	11
Commercial credits	21	15	10
Other debt	13	7	7
<i>Total</i>	<i>100</i>	<i>100</i>	<i>100</i>

Source : Duval (2002)

Transformations in France's Governance Culture

Dismantling the Public Focal Monopoly

The political, economic and social forces that participated in dismantling the governance focal monopoly can be grouped into three types: those which led to the emergence of competing focal points, those which tended to fragment the public focal point, and those which contributed to undermining its legitimacy. These trends were, for the most part, already visible at the end of the 1960s and became irreversible in the course of the 1970s. In brief, they were:

- The rise in the strength of *focal points competing with the state*, which provided several new possible focal points for co-ordinating actors. The *financial markets*, under the combined pressure of European economic and monetary convergence, financial globalisation, and the financing needs of firms and the state, played an increasing role in the life of

economic actors. Second, *Europe* was equipped with legislative, regulatory and judicial powers such that Brussels became the most important focus of lobbying for the largest French firms.

- The *fragmentation of the public focal point* was due, first, to new fiefdoms taking root in the public sector (services, ministries, delegations, special units and *grands corps*) which sought to affirm their strength within the administration, in public enterprises and, increasingly, within ministerial cabinets. This trend sparked incessant quarrels, battles for dominance, haggling and blockages. From the mid-1960s, de Gaulle became concerned that the expansion of this phenomenon would push the national interest into the background, behind that of the multiple private interests competing to harness public funds (Peyrefitte, 1976). The fragmentation further accelerated under the influence of:
 - i*) decentralisation, adopted at the start of the 1980s, which considerably reinforced the prerogatives of local communities, particularly regarding public investments; and
 - ii*) the growing frequency of changes in the government majority and, above all, of periods of “cohabitation” — during which the President on one hand and the Prime Minister and Cabinet (i.e. the Government) on the other were political adversaries — which undermined the cohesiveness of political action and accentuated the politicisation of the senior civil service (Suleiman and Mendras, 1995).
- The *delegitimisation of the public focal point*: First in the public’s eye, the state appeared to favour the interests of an elite more and more, no longer prioritising the general interest. Second, the state appeared overwhelmed by the accumulation of social crises: in May 1968, the legitimacy of the post-war institutions (state, unions, political parties, business, family, church) was publicly questioned for the first time; the consequences of the major industrial crises of over-production in the 1970s in steel, ship building and textiles; the incessant rise in unemployment in the 1980s and 1990s. The credibility of the state and so-called “representative organisations” (of employers and workers) in reaching effective compromise was sorely questioned. From the mid-1980s, the accelerated drain of both young graduates of the *Grandes Écoles* and of senior civil servants into the private sector and the exposure of numerous corruption scandals ranging from local clientelism to major international business contracts further damaged the image of both the civil service and the political class (Mény, 1992).

Impact of this Dismantling on Organised Interest Groups

Once the focal monopoly lost its force of attraction, coalitions of special interests (notably leading oligopolists in the private sector but also unions and public administrations) were prompted to continue their private strategies, but without submitting themselves to the mediation of the focal monopoly. Taking advantage of political stability (consolidation of democracy), economic growth, industrial integration, and political benevolence towards every project deemed “in the national interest”, these organised interest groups (and particularly those at the head of the largest companies and most powerful administrations) consolidated their social, financial and technological strength.

Their independent development trajectories combined with the dismantling of the public focal monopoly led them *de facto* to emancipate themselves from all external control, particularly public, and encouraged them, on the contrary, to take advantage of the antagonisms at work in the public sphere. According to Bauer and Cohen (1981), from the end of the 1970s, large companies’ “private governments” held a veritable *monopoly of expertise* on their strategic objective, to the point that neither the state nor shareholders had the means to participate in its definition. These private governments had become “agents without principals”⁴. Bauer and Cohen (1981) were also able to predict that nationalisations would not change the effective exercise of power at the head of large corporations because an exclusive oligopoly, with codified and compartmentalised methods of selection, had gained control of that power.

In fact, following the 1982 nationalisations, the public sector included 11 of the 16 largest industrial groups, accounting for 90 per cent of financial activity, 52 per cent of national investment and a quarter of the working population. The socialist French state was henceforth the biggest capitalist in the world! One might have expected that the will expressed to “break with capitalism” would have led to a reversal of the process of dismantlement of the focal monopoly, but it did not. On the contrary, the nationalisations supported, if they did not accelerate, the transformation of the French economy. First, they enabled the recapitalisation and restructuring of the most troubled corporations at the end of the 1970s [the same aid defined before 1981 as a “gift to large capital” became, after nationalisation, “a necessary provision to a leading company to bring it out of the economic crisis” (Bauer and Cohen, 1985)]. Second, they drew the large corporations closer to their guardian administrations which, in the end, facilitated the organisation of the state’s methodical withdrawal beginning in 1983 and further reinforced the links among the “public-private” sector elites⁵.

Consequences for the Definition of the General Interest

Confronted with the strengthening of powerful and non-accountable private interests, the mission of the institutions of political governance could have been to influence their actions so that they continued to serve a “higher” interest (e.g. by supporting the institutionalisation or reinforcement of such checks and balances as shareholders, unions, civil society, the judiciary, regulatory agencies). Yet for this to happen, decision makers would have had to:

- take account of the major changes in the economic environment (“The light is at the end of the tunnel,” President Giscard d’Estaing would declare repeatedly between 1974 and 1978);
- concede the end of the governance focal monopoly (which neither bureaucrats nor politicians were prepared to do);
- understand the strong factors offering greater manoeuvrability to organised interest groups and their new strategies;
- and finally, better understand the real mechanisms of power as it operated in large corporations, beyond analyses of capital *ownership* and its supposed impact on corporate governance.

But most of all — and this is why these four points are science fiction — a much sharper distinction between public and private interests would have been necessary. In fact, one of the major unintended and paradoxical consequences of de Gaulle’s policies seems to have been a growing confusion between private and public interests in the very minds of many officials and members of the *grands corps*, who ended up perceiving little cause for conflict or separation between the two (Birnbaum *et al.*, 1978; Warnecke and Suleiman, 1975). The alliance organised in the 1960s between the state and a set of large industrialists had had the effect of “politicising the private sector and privatising much of the public sector” (Birnbaum, 1977; Birnbaum *et al.*, 1978). As early as in 1970, a sign of this was the content of the Sixth Plan, which “appeared to conform almost exactly to the demands of the CNPF [the top French business association]... The Plan had been captured by its clientele” (Hall, 1986).

As explained earlier, in the state’s largely successful effort to rationalise and modernise the national economy, it took an active part in private-sector development and allied with big business. However, what had not been foreseen was the subsequent dependence of the state on these increasingly powerful and autonomous private actors. Reflecting this loss of manoeuvrability for policy makers, the very definition of the general interest

evolved from a political definition (which was clear in de Gaulle's mind) to a "technical" one, in which public-mindedness (*désintéressement*) came to be associated with expertise. The search-process to reach the general interest was thus moving from the field of political negotiation to that of sectoral "expertise", with all the risks of further dismantling the state's capacities and of policy incoherence that such a move entails.

Workers' Organisations in French Corporate Governance

Workers' unions never really tried or even wished to be directly involved in corporate governance (*EDF* is one of the very few exceptions). This fact helps clarify why attempts by government reformers in times of political turmoil to increase workers' involvement in corporate governance and to improve collective bargaining procedures, both under governments of the Right (in 1968) and of the Left (in 1982), were unsuccessful. They did not manage to improve the quality of the "social dialogue", which often remained formal and had little real impact on decision making, especially when compared to German institutions (Rogers and Streeck, 1995). Nor did they prevent a swift decline in unions' recruitment and legitimacy (the unionisation rate lies today around 8 per cent).

Part of this disaffection was due to the unions' powerless reaction in the competitiveness crisis of the 1970s and the subsequent restructuring processes of the 1980s that ended in massive unemployment, wide recourse to "flexible" forms of employment, forced early retirements, "wage moderation", and the individualisation of wage bargaining — all tendencies reflected in a sharp shift in the sharing of value-added in favour of capital (Artus and Cohen, 1998). All these factors combined in turn entailed a further dismantling of the collective-action capacities of French workers' unions, apart from some "bastions" of the public sector known (depending on one's point of view) for their capacity for action or for resistance to change.

A new opportunity for workers' engagement in corporate governance, according to some, might come from the generalisation of employees' collective saving plans. Such hopes actually are not new, and were already unsuccessfully addressed under de Gaulle through two mechanisms, one voluntary (the "*intéressement*" in 1959), the other mandatory for firms over 100 employees (the "*participation*" in 1967), aimed at associating employees to their companies' performances (and, for the latter mechanism, even to its capital and decision-making process). Employers have nevertheless been reluctant to share power, shareholders to share ownership, unions to see their members become

“capitalists”, and workers to take this investment risk. Employees’ savings have thus not been invested in shares of the companies that employ them but blocked in specific accounts registered in companies’ liabilities, so that apart from the risk of bankruptcy the investments remained relatively riskless for employees and available for use by companies without diluting existing shareholders’ holdings.

Employees’ *financial* involvement started to increase in the middle of the 1980s with the introduction of new forms of collective firm-level saving accounts which responded to employers’ wish to link wages to firms’ economic, financial or stock performance. Direct distribution of shares to employees on the occasion of privatisations (from 1986 onwards) supported this trend. However, at the end of the 1990s, the average level of employees’ ownership among major French companies (the CAC 40 major listed firms) was still only 2 per cent (Lazonick and O’Sullivan, 2001).

Furthermore, as far as the *governance* role of employees is concerned, the impact of employees’ savings and stock-ownership plans has remained extremely limited (cf. Balligand and Foucauld, 2000). With a few exceptions (e.g. *Air France* and *Société Générale*), such plans have primarily served as tools at the disposal of managers and have thus had little or no impact on governance as such⁶.

Entrenchment Strategies in the Insider System

“Insider” corporate-governance systems tend to be characterised by relatively airtight resistance of companies’ internal governance institutions to key *external* and *independent* corporate-governance mechanisms (cf. Oman *et al.* (2003) for a comprehensive list of such mechanisms). For example, though a bank can constitute an institution of external control, as soon as it becomes a “friendly” bank by being a passive shareholder sitting on the company’s board of directors, its independence must be called into question. Under these circumstances there is a significant possibility that the bank’s managers may become more concerned with the company’s longevity than with its profitability, which may in turn lead the bank to adopt a more risky loan policy towards the company for the near exclusive benefit of the managers of the two organisations. Similarly, the managers of a company operating in an insider corporate-governance system would be inclined to protect themselves from the power of minority shareholders by concentrating the majority of voting rights in their hands (by personal agreements with the largest shareholders, by gathering blocks of “proxy votes” prior to the annual general meeting, by issuing non-voting shares to avoid diluting power and issuing others with multiple voting rights to “loyal” shareholders, etc.).

The privatisation of state-owned companies launched with the return of the political Right to government in 1986-88 and again in 1993-95 (both during the presidency of Mitterrand) exposed a problem in France's insider system of corporate governance. To use a medical metaphor: if national companies are allowed to leave the (public) hospital, how does one ensure that at the first (profit) relapse they will not fall into the hands of foreign (private) clinics? The strength of an insider system can be perceived in the ability of managers to perpetuate the system, i.e. to entrench themselves even as the challenges from increasing economic liberalisation threaten their hold on power.

An evident sign of this adaptation and entrenchment strategy was the creation of "hard cores" ("*noyaux durs*") of shareholders, established by a small circle of insiders belonging to the economic and political elite. The principle of the strategy was to multiply cross-investments among the country's largest business groups, sealed with medium-term shareholders' pacts (generally around two years) to impede foreign investors from ever taking control. In addition to the 10 per cent of capital given or sold to the firms' employees, these "hard cores" accounted for between 20 and 40 per cent of privatised companies' shares and were sold at a control premium above market price of between 2.5 and 10 per cent (Schmidt, 1996). They always included a friendly bank, acting as a passive shareholder but providing precious financial support (e.g. *Société Générale* and *Alcatel*; *BNP* and the insurance group *UAP*; *Crédit Lyonnais* and *Thomson*).

In this defensive strategy, any method of defending national capitalism and preserving tight control of the hard cores was acceptable. The means included naming senior civil servants close to the government to head newly privatised companies (often the same civil servants who had been responsible for the privatisation or sectoral deregulation programmes), issuing non-voting shares (more positively baptised "investment certificates"), undertaking private sales of stable control blocks of shares, issuing shares with double voting rights, golden shares (which grant the holder veto power over changes to the company's charter), cross directorships....The list is long.

Add these tactics to the intensification of *pantouflage* and the covert financing of political parties by private firms⁷, and it becomes understandable why the ties among many members of France's economic and political elite were tighter than ever. The evolution of this insider system is even reminiscent of what Haber (2002) depicts more formally as a system of "crony capitalism" – a system of governance we discuss in the next chapter.

For Morin (1998), French capitalism was one of "circular ownership" that continued to organise the convergence of interests, though it was largely informal and reduced to one among elites who allowed themselves largely to

ignore the meaning of such concepts as “checks and balances”, the protection of minority shareholders’ rights and “independent directors”. Paradoxically, what best characterised the transformation of French capitalism was the stability and entrenchment of the power structure despite changes in the ownership of capital (Cohen, 1996).

Limits of this Insider System

It was precisely the lack of external means to monitor corporations that brought into question the legitimacy of top management in large French business groups, because in mutually protecting one another they did not submit to any type of external accountability or democratic control. A crisis of legitimacy erupted in the 1990s, due both to the insider system’s reaching its inherent limits (it was inefficient and costly) and to the arrival of new external *and* independent actors into France’s governance culture, which until then had remained very closed. Inherited from the *Trente Glorieuses*, this culture proved itself poorly adapted to the complexity and risks of the new international economic environment.

1) Limits Inherent to the Insider System

The 1993 bankruptcy of the *Crédit Lyonnais* is indicative. For several years, the top managers — drawn from the senior ranks of the public sector (especially the Treasury) — of what was then Europe’s largest bank were able to carry out high-risk operations without any form of control by the bank’s board of directors, by its sole shareholder (the state and more precisely the part of the Treasury in charge of monitoring public-sector companies) or by its regulatory supervisor (the banking commission). Management was, on the contrary, strongly encouraged to increase risky operations — and then to disguise deteriorating results. Loans made at negligible interest rates, acquisitions of nominally “bank-industry” equity holdings made without any real risk evaluation, and property investments during highly speculative periods were all common operations and entailed clear political “gifts” from which French economic elites were able to profit. Their social cost: approximately 20 billion euros⁸. As in the *Elf* scandal (the state-owned oil company today merged with Fina and Total), the confusion between public and private interests reached new heights.

Several other examples can be cited of corporate heads (drawn from the administration, promoted for or protected by their political connections) who led their companies into huge losses without any countervailing power

intervening, either *ex ante* to prevent the slide or *ex post* to take actions against the persons involved. Characterised by great opaqueness and the absence of real surveillance mechanisms (external and independent), France's corporate-governance system (and particularly the governance of state-owned companies) became inefficient and costly.

Nor were these costs associated with the system's downward spiral the only ones. They added to its significant "permanent" costs: massive amounts of capital were immobilised simply to preserve control of the nation's wealth.

According to Morin (1998), 1996 marked the end of this public-finance-centred system in France. That year, *Axa* (an insurance company) acquired *UAP* (another insurance company) and became the most powerful centre of finance in the country. Rather than consolidating the system of "hard cores", Claude Bébear, the manager of the Axa Group, decided to divest the company of its non-strategic holdings (including such major corporations as the *Crédit National*, *Schneider*, *Suez* and *AGF*) since he considered these fixed assets to be a useless cost to the group. The move to untie cross-shareholdings has continued uninterrupted in France ever since.

Still particularly worrying from a minority-shareholder perspective, however, remains the weak role and monitoring means of France's public stock-market regulator (previously the *COB* and the *CMF*, recently merged to create the Financial Market Authority — *Autorité des Marchés Financiers*, or *AMF*) which has failed to prevent or even anticipate (much less impose sanctions in the wake of) many major scandals that have occurred since the market reform of the mid-1980s. Examples of such scandals are those associated with the names of *Péchiney* and *Eurotunnel* at the start of the 1990s, and *Vivendi* more recently. In the same vein, the resources devoted to the public institutions charged with ensuring economic and financial justice (e.g. the judiciary and the police) still appear largely inadequate to ensure their ability effectively to function as major sources of countervailing power.

2) New Actors

The abandonment of the strategy of "hard cores" and cross-shareholdings saw foreign investors, who held only 11 per cent of *CAC 40* firms' shares in 1987, increase their ownership to 42 per cent by 2002.

British and American *institutional investors* have been particularly active among these foreign investors, imposing in the process a previously unknown concept on the agenda of French boards of directors: "corporate governance"⁹.

Already, before they held more than about 10 or 15 per cent of the CAC 40 companies, these investors worried French corporate managers, owners, politicians, unions and finally employees — all “alerted” by the media to a supposed invasion of predatory short-termist Anglo-American funds. In actual fact, however, more than these investors’ demands for corporate performance, it was their demands for *transparency* that made waves.

Although the 1999 *Viénot II* Report on how to improve corporate governance in France failed to call for the disclosure of managers’ remuneration, six months later the employers’ association yielded to the combined pressure of institutional investors and minority-shareholder associations. This requirement was endorsed by the law on New Economic Regulations in 2001. So too did boards of directors, where the practice of cross-mandates and “discrete arrangements” had long been the rule. Slowly, the need to limit individuals’ accumulation of directorships and to include independent directors in board deliberations has begun to take hold.

Yet in spite of these new trends, families still controlled 45 per cent of the CAC 40 companies in 2003 (*Le Monde*, 2003) and 65 per cent of all French listed companies (Dietsch, 2004). Further reflecting the still-considerable entrenchment capacities of incumbent management at the head of many major French corporations, 10 per cent of the directors of the companies listed in the CAC 40 still held 42 per cent of all directorships in 2002 (Bauer and Bertin-Mouroit, 2003).

Yet, if managers want to have access to the important source of finance that these institutional investors constitute, and to preserve their image in the eyes of a globalised financial community and the public, they must submit to their demands for transparency and accountability. In just a few years, a small number of institutional investors have made a strong impression on the thinking of corporate managers. Among the most visible of these investors are the mutual fund Fidelity, and CalPERS, the California Public Employees pension fund. They have often made possible, or at least contributed to the acceptance of, investor activism at shareholder meetings, and the use of the media and the legal system by domestic shareholders (notably fund managers, many attached to large financial groups that traditionally shy away from publicly discussing the management behaviour of their peers) and by associations of employee and minority shareholders¹⁰.

From the mid-1990s, in sum, these institutional investors have contributed decisively to instilling in France’s corporate-governance culture something that ten years earlier would have seemed like science fiction: an embryo of countervailing power.

Notes

1. The (Keynesian) policy followed in 1981-82 by the new socialist government rapidly became incompatible with France's European obligations (particularly its monetary stability engagements). After three devaluations and a balance of payments crisis, President Mitterrand abandoned it in 1983 in order to implement "the austerity u-turn". This choice in favour of Europe was a fundamental determinant of the new monetary policy of "competitive disinflation" and of the liberalisation and deregulation measures launched from 1983. Once again, European construction revealed itself to be a powerful tool in a political strategy of adaptation of the national economy. See Cohen (1996) on this point.
2. A company's ability to self-finance corresponds to its net profits plus its depreciation provisions (and the variation of its provisions for risks and unexpected costs) as a proportion of investment.
3. Some care is needed, however, since the notion of market finance does not cover that of disintermediation: a bond, for example, is both a form of market (non-intermediated) finance, and an intermediated finance if it is bought by a financial intermediary. The rise of market finance does not mean therefore that financial intermediaries and banks are relegated to the background, as they are directly behind a proportion of bond issues and purchases, and introduce the near-totality of the rest. In this way, we can distinguish a "narrow" intermediation ratio (credits / total financing) which declined from 71 per cent in 1978 to 52 per cent in 1998, and a "broad" intermediation ratio (intermediated financing / total financing) which remained stable, only falling from 79 to 75 per cent. "The increasing strength of financial markets does not entail financial disintermediation" (Plihon, 2000). On the contrary, the efficiency of markets relies heavily on that of financial intermediaries.
4. In qualifying the situation of managers at the head of state-owned companies in India (and this can be generalised to the majority of such companies in developing countries), O. Goswami (in Oman, 2003), employs the well-chosen expression of "*agents without principals*".

5. In 1985, the top managers of the 11 leading industrial companies and of the six leading service companies came from the public sector. On average, between 1985 and 1994, half the managers and directors of the “CAC 40” (40 major French companies, analogous to the list of companies in the NYSE’s Dow Jones index) were graduates of *ENA* or *Polytechnique*. In banking, more than 80 per cent came from top civil service jobs (Bauer and Bertin-Mourot, 1995).
6. A look at how the supervisory boards of employees’ stock ownerships plans function helps to clarify why, up to now, the actual balance of power has largely been in favour of management. There are two major ways of attributing directorships in these boards, both leading to the same result. When directorships are distributed proportionally to holdings, managerial staff generally happen to have the majority. When the number of seats is equally shared between management and employees or unions, the latter often disagree among themselves in the face of a united management who then win by a majority of votes.
7. At least until a law passed in 1993 organised public financing of political parties.
8. See on this subject Toscer (2002) for example.
9. Following OECD (2003c), institutional investors mainly refer to pension funds, investment companies (including mutual funds), and insurance companies.
10. For example, among the most active employees’ shareholder associations are those of the *Société Générale* and *France Télécom*; among those of minority shareholders: *ADAM* (Association for the Defence of Minority Shareholders), the *ANAF* (National Association of Shareholders of France), the *AEDE* (European Association of Investment Defence) and the *Adacte* (Association for the Defence of Eurotunnel Shareholders).

*Chapter V***Implications for Developing Countries****Summary**

How can France's experience both with its post-war public governance focal monopoly and with subsequent changes in its governance institutions and practices help to clarify the governance challenges that many developing and emerging-market economies face today? What are the institutional and policy implications for those countries?

Contrasting France's governance paradigm with the Anglo-American paradigm makes it possible to establish a new framework for analysing a country's governance culture. Two key dimensions of a governance culture emerge. One is the extent to which a governance culture relies on informal rules and inter-personal relationships relative to its reliance on formal rules and impersonal institutions. The other dimension is the extent to which, in the interaction among private interests, a governance culture is conducive to the emergence and prevalence of a general interest or at least of relatively broad and encompassing interests among them, relative to the prevalence of trends toward the emergence of rivalry and conflict among a limited number of more narrowly defined ("particularistic") interests.

This framework points to the short-sightedness of seeing corporate-governance institutions in isolation from the governance culture in which they are embedded. It also sheds new light on governance cultures: their logic, their dynamics of change, their limits, and the "traps" (low-level equilibria in economists' jargon) in which they may get stuck. It should be useful to public and private decision makers in developing countries engaged in a process of catching-up development to anticipate better the corporate and political governance challenges they and their countries will face.

Introduction

Given how poorly France's corporate-governance institutions of the *Trente Glorieuses* measure up when evaluated by today's most commonly used criteria for judging the quality of such institutions, as noted earlier, France's post-war development "miracle" presents us with a simple choice: either the quality of a country's institutions of corporate governance is of little significance for that country's long-term economic growth and development, or the criteria most commonly used to evaluate those institutions need to be reconsidered.

Our analysis of the transformations of France's governance culture illustrates the considerable interaction among the quality of a country's corporate-governance institutions, the quality of its public-governance institutions, and the dynamics of its long-term economic development process. Yet the analytical framework put forward by what can be called the "juridico-financial" model of corporate governance¹, derived largely from the logic of the well studied corporate-governance experiences of the United States and the United Kingdom, does not make it easy to understand the dynamism and richness of this interaction in countries whose governance systems differ significantly from those of the United States and the United Kingdom. This shortcoming explains why that framework does a very poor job of explaining how, and how well, France's institutions of corporate governance functioned during the *Trente Glorieuses*.

This difficulty of the juridico-financial framework to elucidate governance systems significantly different from the Anglo-American institutional and cultural model applies not only to France during the *Trente Glorieuses* but to the majority of developing countries today. These countries also share with post-war France a number of common characteristics noted earlier: highly concentrated corporate-ownership structures, a preponderance of the state in financing private investment, a lack of independence of the judiciary, etc.

Rather than seeking to assess the multitude of institutional arrangements in developing countries through the sole lens of evaluation criteria derived from the experience of Anglo-Saxon countries, as users of the juridico-financial framework widely tend to do, would it not make more sense to seek to increase the utility of the analytical framework of governance cultures by enlarging it? Such is the aim of this chapter. Indeed, after briefly examining the experience of several developing countries, we will better understand the extent to which corporate governance and public governance effectively take on their full meaning only in relation to one another.

The chapter seeks to address two central questions: How can the French paradigm of the public governance focal monopoly help us to grasp this diversity of governance systems, and thus to understand better the challenges of transformations under way in the institutions and practices of corporate governance in developing countries? And what are the policy implications?

A New Interpretative Framework for Governance Cultures

Vested Interests vs. the General Interest

France's governance focal monopoly of the *Trente Glorieuses* shows that the key role of the institutions of public governance was to modify the structure of incentives and information in the interaction among private interests so that, in pursuing their particular interests, the most powerful private interests tended (also) to serve the public interest (i.e. the collective national interest). For Jean Monnet, father of Europe and founder of the Plan, this meant ensuring that "private initiative bent of its own accord to the needs of the general interest" (Monnet, 1976).

The institutions of governance — both corporate governance and public governance are implied by "governance" — therefore had to resolve two problems: to ensure *i*) the emergence, or identification, of a "common interest" ; and *ii*) its accomplishment. The first raised the question of the appropriate mechanisms of deliberation and consultation among diverse interests, according to the level of governance²; the second raised the question of the appropriate means of achieving co-operation and co-ordination among them.

The role of governance institutions is thus *to ensure that the interplay among key actors in society is never reducible to a mere expression of power, but continuously allows the emergence and realisation of a common interest, among them.*

If not, the risk is great that power struggles between predatory interest groups (Olson's "distributional coalitions") will spread across the national economic and political landscape, degenerating into a significant loss of wealth — a "negative-sum game" — for society as a whole (see Oman *et al.*, 2003). Two paradigms of societal regulation of struggles among vested-interest groups can be envisaged:

- One is the *competitive* regulatory paradigm, in which no agent is supposed to hold enough power to be able to distort competition, i.e. to be able, acting alone, significantly to influence prices (this is the founding principle

of the “invisible hand”). The interaction among actors is thus framed by juridical rules and appropriate financial incentives. A number of institutions charged with ensuring that the rules of the game are respected provide the necessary arbitration and degree of balance among competing private interests (see Box V.1).

- Another paradigm is that of the *focal monopoly*: a hierarchical (even hegemonic) regulation of private interests that “organises” their convergence towards the general, national interest. In Olson’s (1982) terminology, the role of the focal monopoly can be compared to that of an “encompassing” (as opposed to narrowly based) organisation that is widely inclusive of private interests, particularly the most powerful or potentially influential groups and individuals, and whose base is sufficiently broad that the group will tend, of its own will, to serve the general interest.

Our point in distinguishing these two paradigms is not to exclude the likelihood that intermediary or alternative systems may also be functional. It is to draw attention to the fact that both paradigms act — in different ways — with the same tools in seeking to resolve the powerful contradiction that always potentially exists between the interplay of private interests and powers, on one hand, and the emergence and accomplishment of their broader collective interest, on the other.

Box V.1. Two Conceptions of the Law and the General Interest

The “market culture” so defined is intrinsically linked to a culture of open competition or contests between private interests in countries whose judicial foundations are those of Common Law: “American law, born of English law [...] is founded above all on the case by case resolution of conflicts submitted to judges. It is the repeat of previously established solutions and their sedimentation that formed jurisprudence — the primary source and legitimacy of law. To this method of developing law, which confers principal importance to trials, a culture of conflict is joined in the sense that law is perceived across individuals’ prerogatives: these prerogatives opposing each other [...]. Consequently, conflict — in the form of calm debate or in its judicial form of resorting to trials — corresponds to the American conception of achieving rights. [...] [Law is defined as] that which holds the interest of each in balance” (Frison-Roche, 2002).

Box V.1. (contd.)

In contrast to Common Law countries, the juridical tradition born in continental Europe is founded on texts, constructed around the fiction of the “general interest” which organises the legal system in an abstract, and supposedly perfect, manner. Conflict in this system is *a priori* an indication of a failure of the law. Rather, harmony is natural. How does this legal concept translate to the business enterprise? The legal systems of continental Europe established the corporation as a legally recognised entity between the end of the 19th and the first half of the 20th centuries. They affirmed the corporation’s independent existence and ends. All stakeholders in a corporation (minority and majority shareholders, employees, managers, clients, suppliers, etc.) are under a legal obligation to act in the interest of the “society” (the generic legal name of a corporation, conceived of in law as a society of people and capitals). The interest of the corporation (*intérêt social*) is understood in public law (*droit public*) as a collective interest that reflects, at the level of the company, the general interest, irreducible to that of any stakeholder or subset of stakeholders. Yet how, in actual business practice (as distinct from legal conceptions of reality), should private interests organise their mutual integration to serve their general interest? This process does not occur spontaneously and, of course, it is most often the managers who find themselves in a position to determine the effective content of the general interest of their “society”.

Inter-personal vs. Systemic Approaches to Confidence, Power and Information

Chapter III identified confidence building, the devolution of powers and information management as the primary instruments which the governance focal monopoly used to attenuate the inherent tension between the pursuit of particular interests and of the general interest in post-war France. The juridico-financial model assumes that legal rules and appropriate financial incentives can resolve this tension by themselves, without recognition of the need for trust (see Blair, 2002). But given that judicial institutions in many developing countries have very limited financial resources and powers of deterrence, and thus have limited effectiveness and credibility (which are needed for trust), it is unrealistic to expect such countries’ governance systems to rely solely on legal and financial incentives. This lack of realism is further exacerbated by the fact that to be effective in developing countries such incentives must actually be much *stronger* than in advanced countries, if they are adequately to ensure that those actors who exercise power in the name of the collective interest do not divert that power to favour their private interests.

Our hypothesis is thus that a country's governance culture can be characterised by the predominant way in which trust, power, and information are handled (i.e. are produced, organised, allocated, shared and exchanged) within the country.

Trust enables people to make credible assumptions about one another's behaviour that constitute a basis for the co-ordination of mutual expectations, the building of common understanding of adjustment mechanisms, the transmission of information, the achievement of agreements, the reduction of monitoring costs, etc., all of which facilitate their engagement in long-term relations of co-operation with one another. The predictability and the flexibility resulting from trust reduce the costs of long-term investments for all types of "investors" (in physical, human and social capital). Trust thus facilitates, sometimes even makes possible, such investment activity.

Power also "influences the selection of actions in the face of other possibilities" (Luhmann, 1979); but where two individuals who trust each other will make reciprocal positive assumptions, an individual in a position of power will suggest to a subordinate that a particular course of action is undesirable and link it to a threat of sanctions. So the modes of selection of expectations differ. Depending on the credibility of threats, and how much subordinates fear them, power can also be an effective means to coordinate individual expectations and social interactions.

A key question follows from this observation: How do governance systems generally produce confidence, power and information? One may distinguish two generic models:

- One is based on highly personalised relationships between individuals who are aware of their mutual interests and familiar with each other's preferences. Systems that predominately rely on such a method to produce and share trust, power and information are sometimes referred to as "*relationship-based*" systems of governance. They do not preclude the existence of formal rules; but some of the most important rules, known by all key players, remain essentially informal, tacit, non-codified. For a neutral third party to verify that these rules are respected is thus difficult, and at best costly, since third parties tend not to have access to the necessary information on which to base an impartial evaluation and eventual arbitration. The workings of key elements of France's civil service ("*les grands corps*") and of the Chinese diaspora in East and Southeast Asia are two good examples of such strongly relationship-based systems of governance ("*guanxi*" in Chinese) (Woo-Cumings, 2001). Relationship-based trust, power and information are handled on an inter-personal

and often idiosyncratic basis, tied to such highly personal characteristics of individuals as their family or ethnic affiliation (and resources, as far as power is concerned). These inter-personal modes of functioning played a decisive role both in the success, and in determining the limits, of the corporate-governance institutions in France during the *Trente Glorieuses* and in Asia during the “Asian Miracle” from the 1960s to the 1990s (Rajan and Zingales, 1998; Shuhe Li, 2000). They also predominate in the majority of developing countries today.

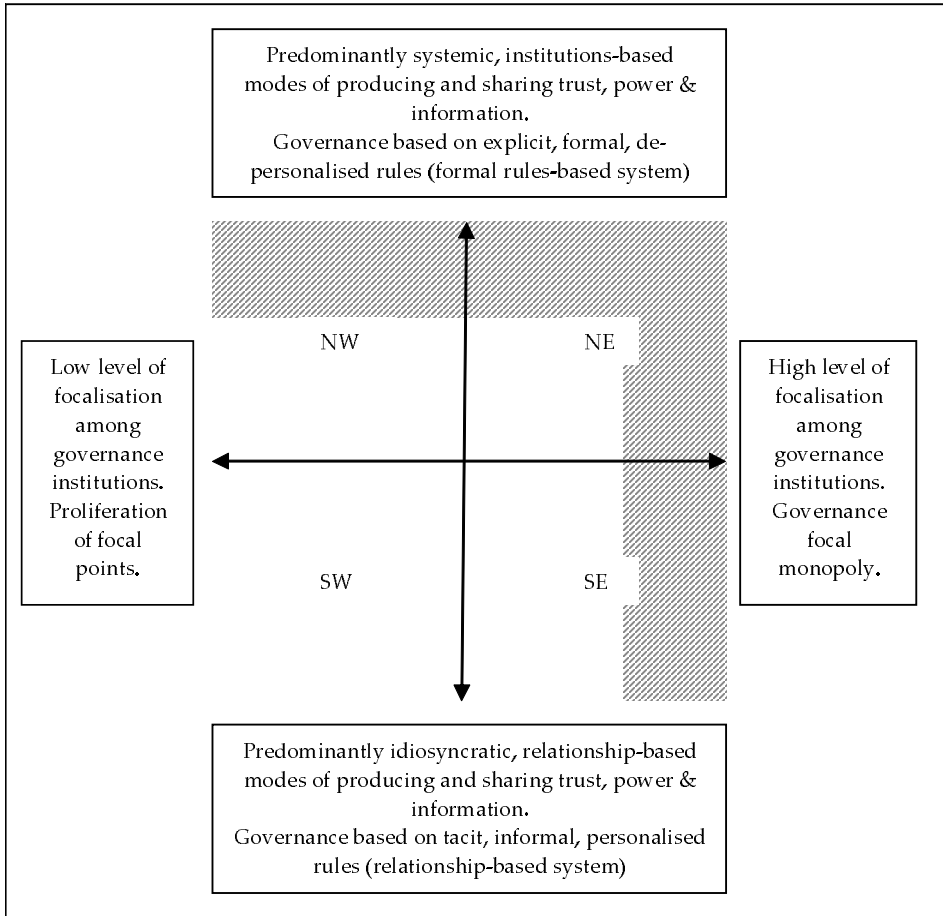
- At the other end of the spectrum are systems (sometimes referred to as “rules-based” systems) where high levels of trust, power and information are secured through much more *impersonal* means in the normal functioning of the governance system. Production and sharing of trust, power and information may thus be characterised as “systemic”, i.e. strongly institutionalised. Such systems are founded on a set of explicit, formal, universal, de-personalised rules. The basic social function of legal norms lies in their ability to channel individuals’ behaviour *and* expectations about others’ behaviour, in the same manner for all individuals, whether or not they are personally acquainted, and generally without sanctions even having to be explicitly discussed when organising a transaction or set of transactions (Luhmann, 1979). Commercial law, contract law, corporate law, property rights, and the credibility of their enforcement, as well as the disclosure and publication of information required for third-party monitoring, are all of crucial importance for an economy to be able fully to take advantage of such a mode of building confidence, organising power and sharing information. This model is well illustrated by the United States, where public regulatory authorities and, above all, politically independent judicial courts with adequate means of investigation and enforcement act as the principal arbitrators in a system that functions on the basis of a large quantity of information made available to private actors by the whole system — actors who thus have the means and responsibility to protect their particular interests before the arbitrator.

In practice, of course, hybrid forms of trust production, power organisation and information sharing are likely to be found in any governance system. Also common are intermediary modes that combine elements from the two already described (inter-personal and institutional). Such intermediary modes may be termed *process-based* systems in which trust is built through repeated exchanges among actors who do not initially have strong inter-personal relationships (cf., Zucker, 1986). Such repetition over time can enable the establishment of *reputations*, for example, among networks or communities.

Modelling Governance Cultures

Figure V.1 presents a synthesis of the preceding analysis in the form of an interpretative framework of governance cultures.

Figure V.1. **Governance Cultures in Two Dimensions**



- The vertical axis reflects the degree of personalisation vs. de-personalisation in the functioning of governance institutions, i.e. the effective degree of reliance on formal regulation within a governance system. The United States would be positioned relatively high (to the north) on this axis because of the relatively high degree to which interactions among particular interests are effectively governed by

impersonal rules. Systems predominantly based on inter-personal ties of trust and power and generally informal rules of governance are found below (to the south).

Three observations are called for here.

- 1) A high position on this axis does not mean an overall *superiority*. By way of illustration, it might well be that, in such high-positioned systems, individuals rely so much on impersonal institution-based (or systemic) mechanisms of confidence-building that they end up suffering from too low levels of relationship-based (or inter-personal) trust in key economic aspects and/or, perhaps especially, in key non-economic aspects of their lives (e.g. see Putnam, 2000).
 - 2) The general pattern, not the exception, is to find multiple or hybrid forms of trust, power and information sources among and within a country's governance institutions. Silicon Valley offers a good illustration (cf. Aoki, 2000).
 - 3) As emphasised by Giddens (1990) in his theory of trust, even when trust is mostly produced at a systemic level, actors' observable behaviour remains important for the process of actually establishing systemic trust. By offering face-to-face commitments to potential users or clients, for example, individuals at the "access points" of formal abstract systems (e.g. the monetary or the legal system) fulfil the crucial task of permanently translating formal rules into meaningful concrete practice. In other words, even if face-to-face contacts are not able to produce a high level of systemic trust by themselves, they make possible the "re-embedding" of de-personalised institutional structures (e.g. anonymous standards, rules, procedures) into individual interactions, without which systemic trust would not exist.
- The horizontal axis reflects the degree of effective conflict, rivalry, competition or anarchy vs. induced co-operation or hierarchy in the interaction of interests in a country at a particular time. Located on the left (the west side of the figure) are systems characterised by a multiplicity or a proliferation of governance focal points, which may be mutually contradictory, conflicting or merely "countervailing". In this area, there is of course a stronger risk that the interaction of interests becomes one of confrontation among conflicting forces without any form of general (i.e. largely encompassing) interest able to emerge, much less be accomplished. The absence of a unitary focal point will generally reflect a weaker state role in co-ordinating private interests, with a greater risk of degenerating into anarchy, independently of the formal type of political regime³.

Moving on the horizontal axis from left to right (to the east), one finds systems characterised by more centralised, hierarchical, monopolistic or even a unitary governance focal point. France at the beginning of the 1960s would thus be located on this axis to the right (eastern) side of the figure. The United States would be more to the left (west) than France, given not only the effective separation and relative balance among the three powers — legislative, executive and judiciary — within its federal structure but also the significant decentralisation of many relevant powers to numerous sub-national jurisdictions, and the considerable weight of private interests and associations in the real workings of its economic and political governance institutions.

States and markets are both key organisations and institutions for the coordination of interests, given their special capacities for producing coherence among diverse interests. Yet other organisations and institutions can also contribute to producing such coherence; community organisations, private networks, business and civil-society associations, labour unions, big business groups (e.g. Japanese *zaibatsus* prior to the Second World War and *keiretsus* after the War) and local governments (e.g. in China after 1978) as well as provincial or regional governments (and states in a federal system), for example, all have the potential to constitute effective governance focal points (see Hollingsworth and Boyer, 1997).

Particularly interesting is the case of Italian “industrial districts” whose emergence and effective functioning as self-regulated local focal points can be largely understood as a response to the state’s failure to provide necessary public goods. The serious problems that can be caused by state failures highlight the potential value of non-state solutions of society’s need for governance focal points.

- The hashed section reflects a situation where governance cultures improve the degree of coherence among the actions of private interests to the point that their actions also serve the general interest.

Governance Cultures and Development

“Climbing to the North:” Almost Inevitable

Many developing countries were about to begin, or had just begun, to industrialise in the 1950s and 1960s. The principal way of producing trust, power and information was inter-personal. Most did not have state structures

that could provide unique and functional focal points. In Figure V.2 below, they were thus positioned in the southwestern zone (“initial situation” circle). This configuration still characterises many developing countries at the start of the 21st century. It can be illustrated by North’s (1990) example of a small, closed, peasant community where transaction costs are low (with only a limited number of face-to-face transactions) but production costs are high (because the scale of specialisation and the division of labour is limited by the small size of the market).

Yet as the economy’s openness and integration into the regional (or world) economy progresses, local individuals and organisations are inevitably involved in more and more complex and continuous flows of information and commercial and financial transactions with individuals and organisations who are not part of the local relationship- or process-based system. Local actors face increasing incentives to take advantage of the opportunities for impersonal exchange outside their local system, creating new scope for opportunistic behaviour by such local actors who thus increasingly face the temptation to be unfaithful to traditional relations owing to the nearness of competitors. Since local transactions remain essentially based on personal relationships, they continue to be characterised by significant variable costs (the relatively high marginal cost of the specific investment in each relationship).

These high variable costs increasingly become unaffordable for local individuals and organisations: face-to-face relations can no longer serve as the only way of generating trust and processing information (see Zucker, 1986 and Shuhe Li, 2000). Some of the costs of generating trust and sharing and processing information have to be “mutualised” – institutionalised locally – in order both to limit the rise of (variable) transaction costs in the increasingly complex economy, and for the local economy to benefit from productivity gains that can be derived from greater scales and scope of activity and improved technologies.

Governance by impersonal, explicit and well-enforced rules that apply equally to all – i.e. rules-based governance – offers precisely the advantage of allowing each transaction, especially between strangers, to be handled at a smaller marginal cost than in a predominantly relationship-based system. While the sunk or fixed cost for society as a whole of producing the institutions that are required for rules-based systems of governance to function may be immeasurably greater than those required for a relationship-based system, what matters most for each local actor (individual or organisation) is the *marginal* cost per additional transaction, which tends to be immeasurably *lower* in a rules-based system. Herein lies the economic “comparative advantage” of a rules-based system vis-à-vis a relationship-based system.

Governance systems still predominantly founded on inter-personal or process-based relations are also made progressively more vulnerable when local actors take risks that can no longer be managed within the existing governance framework (a framework better adapted to a lower average level of uncertainty and complexity). Informational asymmetry is greatest vis-à-vis foreign actors — such as major suppliers of funds through portfolio investments in the local economy — who often lack the information they need to be able adequately to evaluate the quality of local governance practices in a context of unexpected change. The exposure to systemic risk by such predominantly relationship-based governance regimes, when they open themselves to interactions with major foreign actors who nevertheless remain in a position of significant information asymmetry, is thus increased considerably.

It must also be stressed that in itself “transparency” is of little value for a purely relationship-based system. Transparency only becomes strategic when local actors undertake to transact with major external actors, notably investors, who do not have the knowledge of the local system they need in order to engage confidently in transactions. The problem is especially acute when these external actors are accustomed to highly developed rules-based systems where high levels of trust and information are produced by the system itself — levels which they are more likely to assume and mistakenly take for granted.

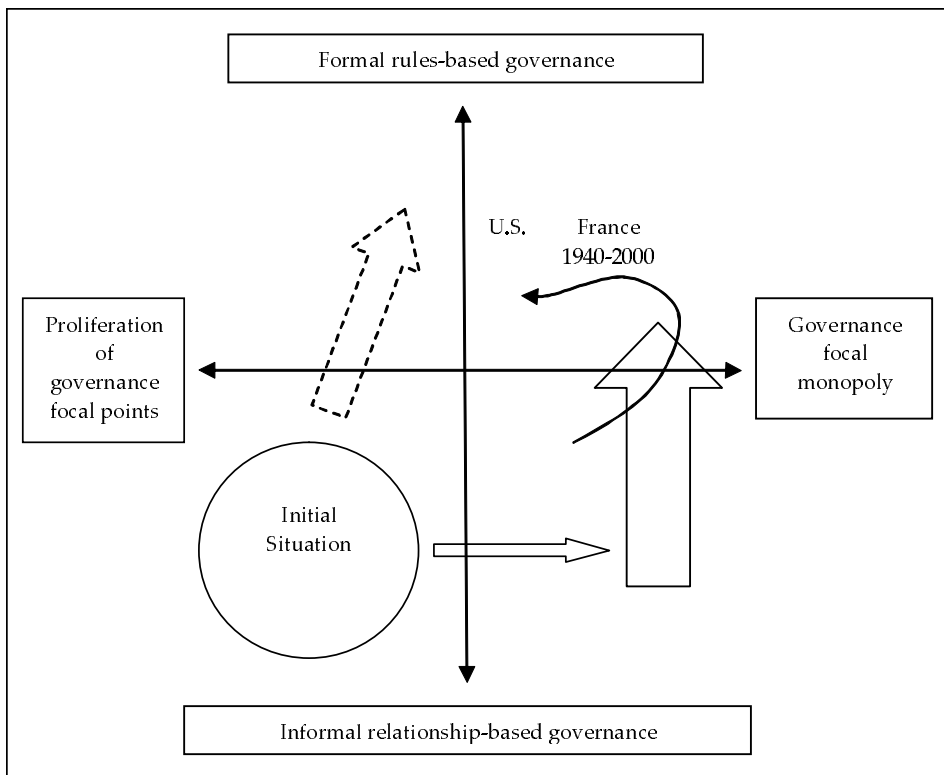
Reactions of financial panic during the Asian crisis can be partly interpreted as reflecting such a gap between foreign portfolio investors’ “cognitive framework” (which was shaped in and by highly formal rules-based systems) and the reality of the governance systems of the Asian countries in which they had recently invested (and until the crisis had neglected or taken as acceptable) whose “opacity” could suddenly no longer be ignored. Unfortunately, but not surprisingly, these investors’ cognitive framework did little to help them correctly to interpret and assess the reality behind that opacity (in casting doubt on the sustainability of Southeast Asian growth three years before the crisis, even Krugman (1994) had not pointed up any particular problems of governance in the region). Lacking any credible basis for understanding the crisis and thus confused, many investors made the “rational” decision of disinvesting — even though, ironically, the crisis countries were in the midst of a transition to more formal rules-based systems (e.g. South Korea was hit hard despite its level of institutional development).

It is thus no mere coincidence that societies located in the north of Figure V.2 often describe themselves as “information societies”, and place great importance on “financial communication” and “transparency”, both of which are crucial to the systemic requirement of mass-producing information. This

need for information puts transparency and disclosure at the heart of the governance mechanisms required by a rules-based society for the production of confidence and organisation of power. Apart from the theoretical case of a permanently closed economy, any society will therefore have to move forward in terms of systemic production of trust, power and information if it is not to suffer from a deepening disadvantage (all the more so in a context of globalisation).

With respect to a country's governance institutions, and referring again to Figure V.2, the difficulty lies in the distance separating the "initial situation" circle from the governance paradigms where private interests are most effectively reconciled with one another in ways that favour the general interest (shown in the hashed area of Figure V.1). For countries in the SW quadrant, the question then is: *which path* to adopt in order to raise the domestic governance system to the level required for achieving international competitiveness?

Figure V.2. "Climbing North" or "Progressing via the East"?



Two Options

The main problem for heavily relationship-based societies is that despite all its potential advantages, the institutionalised or systemic production of trust and organisation of power and information-flows entails very high fixed (collective) costs: those of making the necessary investments in the creation and maintenance of legal and judicial infrastructure and of the surveillance and regulatory bodies needed to define and enforce such ancillary institutions as codes, standards, norms, guarantees, contracts, property rights, and commercial, bankruptcy and corporate laws – all of which must themselves be adequately well-governed – over a period of time sufficiently long to gain the confidence of investors (very broadly defined). Given the human and financial resource constraints developing countries face, and exacerbated by the time pressures they are under in times of globalisation, most do not have the means for this investment in either the short or medium term.

The more feasible solution (in terms of efficiency and cost) for many developing countries may therefore be to attempt the adventure to the east and seek out a passage via this route, rather than seeking to climb directly to the north⁴.

Recommendations made to developing countries on improving their governance institutions tend, rightly, to insist on the importance for those countries of equipping themselves with robust, transparent and responsible governance institutions based on respect for the rule of law (see for example World Bank, 2001). Yet in receiving and hopefully trying to implement this advice, the sights of policy makers in developing countries will naturally turn in the direction of the desired result: to the north, following the dotted arrow in Figure V.2, towards a point corresponding much more to an idealisation of American institutions and practices. The typical situation is thus one that Qian (2001) captured well with a metaphor: “The most delicate problem for mountain climbers (developing countries) is less to see the summit than to find *feasible* paths to reach it.”

Moreover, highlighting the importance for developing countries to seek to develop rules-based systems of governance should not allow us to forget either the path actually taken in the past by many of today’s developed countries to establish rules-based systems, nor the continuous efforts they find necessary to make even today in order to remain on it (for an excellent reminder of the latter, see the survey on “Capitalism and Democracy” in *The Economist*, 2003).

Too often, recommendations made to developing countries today to improve their systems of governance seem to minimise the fact that the most advanced economies already have at least a century and a half of industrial development behind them. This lengthy period permitted organisations, institutions and individual behaviour to transform incrementally; today's apotheosis reflects the achievement of a *relatively* stable and coherent institutional setting, generally situated in the NE zone of Figure V.2. Yet since the recommendations widely made now to developing countries for successfully achieving a direct ascent to the north are well understood, how else to explain, if not by forgetfulness, why actually implementing those recommendations appears widely to be very problematic? Perhaps the recommendations neglect an essential, concrete feature of all corporate-governance systems and of governance cultures in general: the horizontal dimension of the two figures.

Advantages of the Focal Monopoly

Given the feasibility and position (at the very right on the figure) of focal monopoly governance systems, a relatively authoritarian or *dirigiste* government can sometimes constitute more of a help than a hindrance in setting up such a system. It is in this way that the option taken by France in 1940, Chinese-Taipei in 1949, Singapore under Lee Kuan Yew from 1959, South Korea under Park Chong Hee from 1961, and China in 1949 can all be understood⁵. This transformation of the capacity of public governance institutions to organise private interests by positioning themselves as the incontestable focal point in governance relations is a distinctive feature common to all these countries. Such a transformation corresponds to the move towards the right shown by the thin horizontal arrow in Figure V.2.

It should nevertheless be stressed that it is not because a state is authoritarian or *dirigiste* that it is necessarily capable of putting in place a functional focal monopoly. Many African and Latin American countries illustrate such incapacity; Argentina under Peron from 1946 to 1955 and its other military dictatorships is but one important example. Nor does democracy guarantee that the group in power will be sufficiently encompassing — sufficiently inclusive or representative of different private interest groups, notably among the elites — to permit a focal monopoly to function adequately for the long-term general interest (e.g. democratic Argentina since 1983). Indeed, if the strategy of public focal monopoly never fully and durably functioned in Argentina, it is because neither democratic governments nor

military dictatorships succeeded for an extended period to reconcile particular interests well enough to serve the general interest in a sustained manner. The state lacked the capacity to assemble enough private interests (essentially, those with enough power to ensure that their interests counted) in order to ensure that their common interests would prevail over their differences and, in the process, enable a sustained process of national economic development. On the contrary, the country was tragically characterised by incessant power struggles between strong, competitive and antagonistic interest groups, in an *oligopoly* of power, who did not manage to interact in the (same) focal monopoly in a sufficiently durable way.

In many countries, the state has sought to play a central role in promoting the nation's capitalists. But, in the majority of cases, not being sufficiently attentive to the large spectrum of interests whose mobilisation was necessary for development, the state has tended rather to reinforce the rents that a certain number of private interest groups have extracted from the (public and private) investments and protections put in place, without achieving the development of a national base of governance institutions and large corporations that could have launched the country on the road to sustained economic development. Bad corporate and public governance have, on the contrary, tended to mortgage the adaptive capacity of many developing countries, and to polarise and rigidify their societies⁶.

States with functioning focal monopolies (i.e. those in a position to orient the private logic of coalitions of particular interests towards the general interest), on the other hand, have organised themselves, for sufficiently long periods, to render the interests of economic, social, administrative and political elites compatible with each other — notwithstanding the inevitable tensions among and within these groups — and thus promote their collective interest as much as possible by avoiding situations of continuous conflict. Qian (2001) thus shows, for example, that if the majority of reforms since 1979 in China have produced positive results, only since 1979, it is notably because the leaders since then have paid constant attention to the interests of different societal actors involved in the reform process (and above all, to those of different factions of the elite themselves), even if it meant taking non-conventional paths *a priori* surprising to foreign observers⁷.

Subordinate to the priority of ensuring the prevalence of the general interest among elites is another key challenge: that of rendering elite interests compatible with reasonably equitable growth, i.e. growth whose benefits are diffused across the population. Meeting this challenge is important not least

because discontent among the working classes (or key factions among them) can be susceptible to exploitation by one (or more) faction(s) of the national elite who would seek to destabilise an existing balance of power in order to try to tip it more in their favour.

Countries that have had reasonably successful recourse to public focal monopoly governance systems are thus characterised by the creation of unique institutions of dialogue and co-ordination among elites, in which trust is necessarily based on a foundation that is *simultaneously* inter-personal, process-based and institutionalised. Examples are France's Planning Commission, Korea's Economic Planning Board, Singapore's Economic Development Board and National Wage Council, the Industrial Development Commission and the many associations created under the Kuomintang in Chinese-Taipei, and more generally, especially in the fastest growing East and Southeast Asian countries, the numerous structures institutionalising regular exchanges of information and opinion among administrative, political, economic and even labour-union leaders (Amsden, 1997; Lee Kuan Yew, 2000; Rodrik, 1994; Root, 1996; Woo-Cumings, 1999). Voluntaristic policies were also pursued with the intention of "leaving no-one by the side of the road", even if it entailed making sizeable transfers to the least privileged parts of the population⁸.

All of these measures were fundamentally aimed at ensuring a minimum of equity among social groups in order to ensure social cohesion – between "popular" and "dominant" classes, and above all among factions of the latter – and thereby decisively strengthen the *credibility* (Huff *et al.*, 2001) and hence the *feasibility* of public policies (since a very large proportion of those on whose implementation public policies ultimately depended, in such a system, were involved in their design and adjustment). These measures made it possible to increase significantly the *predictability* of policy decisions that would have an impact on corporate governance over periods sufficiently long to produce beneficial effects on investment⁹.

In sum, the measures increased the level of institutional and process-based trust, power and information in societies previously based predominantly on personalised modes of trust production, power distribution and information processing¹⁰. This contribution is represented in Figure V.2 by the large vertical arrow indicating a rapid ascent of these countries into the northern half of the figure, facilitated by the attributes of a sole and uncontested focal monopoly in governance relations, notably at the interface of corporate and public governance.

Care is still needed, however, because there is no guarantee that governments apparently benefiting from a position of focal monopoly will generate positive effects. The case of Chile during the 1973-82 period provides a case in point: the ties between the highly ideological leaders of the political economy in Pinochet's government and a very narrow — manifestly too narrow — circle of private corporate insiders led to the emergence and domination of a few conglomerates, but to the detriment of several other private sector interests and that of the macroeconomic stability of the country. Those insiders used their relations with the regulators and the banks, which they owned, to diversify their operations in the financial sector, to increase their debt without checks, and to widen their empires (see the chapter on Chile in Oman (2003)).

The example of Chile is all the more interesting because following the country's financial crisis of 1982/83, and although the nature of the regime did not change, General Pinochet — no doubt in order to avoid an alliance of the traditional employers with the (growing) opposition to his regime — significantly increased the scope of economic elites' interests taken into account in the elaboration of policies by his regime. The Confederation for Production and Commerce, highly influential and representative of the traditional sectors of the economy, was thus charged over the coming years — both during the military dictatorship until 1988, and afterwards in the framework of democracy — to collect systematically the proposals of the different associations in each sector, to establish a consensus among them, and to make this a base for negotiating with political authorities (Silva, 1997). The consequence was markedly better economic results¹¹.

By similar processes, organised dialogue between private sector organisations and the Mexican government decisively contributed to the success of that country's 1987 stabilisation plan (Economic Solidarity Pact) and to its economic opening (the NAFTA agreements, concluded in January 1994) (Schneider, 1997). Such visible, formal and institutionalised platforms of negotiation, between broadly-representative private sector organisations and political leaders, appear to have existed less durably in Brazil¹² as in many other developing countries.

The absence in the latter of such organisational and institutionalised formal dialogue and co-ordination capacities multiplied the potential entry points for private interests, and paved the way to all sorts of informal arrangements based on inter-personal affinities at every level of administrative and political responsibility.

*Crony Capitalism: Another Alternative to Rules-based Governance?*¹³

In the large majority of countries where political and economic elites are closely linked, such proximity is often now labelled “crony capitalism”. How does one distinguish between a governance system characterised by institutionalised dialogue and coordination and one characterised by “cronyism”? Where can we draw the line, in other words, between healthy and harmful proximity among political and economic elites? In brief, to what precise illness does “cronyism” refer, and why do so many countries catch it?

One of the major governance dilemmas, as explained by North (1990) and others, is that if the state is strong enough to protect and arbitrate property rights, it is also strong enough to abrogate them and engage in predatory behaviour towards private holders of assets. The threat of predation discourages private initiative, especially productive investment, and thus limits long-term growth. As Haber (2002) explains, the solution is for the state to tie its own hands: “Unless the government can find a way to tie its hands, asset holders will not invest. If asset holders do not invest, there will be no economic growth. And if there is no economic growth, the government will be unable to finance its needs because there will be insufficient tax revenues. How can a government create a credible commitment that it will not use its powers to either tax away all the rents created by property rights, or completely abrogate these rights?”

One solution is reserved to countries located in the northern half of Figure V.2: a state “ties its own hands” by developing solid institutions – institutionalising checks and balances on and within its own organisation of power – that prevent it from acting in an arbitrary manner. As underlined above, the problem with countries located in the SW quadrant is that such a set of self-enforcing institutions is generally out of reach because it entails large fixed costs (which they cannot afford) and requires long experience (which by definition they do not have) before those institutions are properly functioning. Indeed, the further south they are, the bigger is the investment needed to climb directly to the north, and the less realistic opting for a limited government seems; the further west they are, the more they are prone to political instability due to conflicting factions of vested interests, and the less attainable the option of a governance focal monopoly seems.

In both cases, crony capitalism may be viewed as another alternative to a formal rules-based system for “tying the government’s hands” and establishing enough credibility to induce productive investment. The logic of a crony system is “to guarantee a subset of asset holders that their property rights will be

protected.[...] As long as their assets are protected, these asset holders will continue to invest as if there were universal protection of property rights. Thus economic growth can occur, even though the government is not limited" (Haber *et al.*, 2002). Yet arrangements between cronies tend to be informal and implicit, which gives rise to a new "commitment problem": the government can still change the rules of the game and confiscate the wealth created once asset holders have invested. The question is then, again, how can the state in a crony system credibly tie its hands?

"The answer is that members of the government itself, or at least members of their families, must share in the rents generated by the asset holders" (*ibid.*). Clear illustrations of that principle may be found in such mechanisms as the *pantouflage* for aligning interests among members of the elites, and the pervasive involvement of dictators' families in their economies so that political elites have strongly vested interests in maintaining the rents generated throughout a wide range of national economic activities. The incentive to integrate further economic and political elites increases when political instability renders the promises made by factions of the political and economic elite to each other much more difficult to uphold. As Haber *et al.* (2002) argue, following the economic reasoning of Klein *et al.* (1978), political and economic elites are placed in the situation of two firms trying to contract "when there is no third-party enforcement and both sides have incentives to renege after the contract is signed. [The costs of contracting become so high owing to potential opportunistic behaviour that] they will have an incentive to integrate rather than abide by a contract. [...] Vertical integration may be either backward by allowing economic actors to write and enforce the rules governing their own activities, or forward by encouraging politicians to engage directly in productive and lucrative activity".

It must be emphasised, crony capitalism is not necessarily incompatible with strong growth over relatively long periods, as the example of Mexico under Porfirio Diaz provided by Haber *et al.* (2002) illustrates. Yet crony capitalism is plagued by major shortcomings¹⁴.

First, crony capitalism is *economically inefficient*. Rents have to be permanently created and distributed to crony asset holders to induce them to invest. Among the most common sources of such rents are access given by the state to cheap finance (national banks are particularly exposed, though not necessarily the only source) and the provision and protection of local market shares (either directly, as through government procurement, or indirectly, as through high import tariffs or other barriers to imports, barriers to inward

investment, and even requiring state authorisation for market entry by domestic firms) and protection against competition. In these conditions, it is almost certain that oligopolies, monopolies or even entire industries will be created, extended or maintained that should not be, whereas other opportunities will not be exploited even though they would be socially useful, internationally competitive, and local entrepreneurs have the necessary skills.

Second, crony capitalism leads to *short termism*: it is not possible for any single faction competing for or exercising power in a crony system to commit in the long term since its commitment will probably only last as long as it remains in power. Fearing they may lack political connections in the case of a political change, cronies therefore tend to operate with short-term horizons and demand high rates of return.

Third, crony capitalism is *socially predatory*: the different types of rents noted above do not fall from the sky. They will generally be extracted from society as a whole (through higher prices, rising taxes, lesser quality of public services, etc.). The machinations of rivalry among powerful oligopolists can also consume significant resources. All these social costs are accompanied by a widespread mechanism in crony systems: the concentration of returns in private hands (social returns are “privatised”) and the spreading of risks (costs or losses) through society as a whole (risks and costs are “socialised”).

Fourth, crony systems are *difficult to escape*. Society runs a high risk of finding itself caught in a governance “trap”. The size of cronies’ resources (the rents they control, their powerful political and economic connections, their financial strength and ability to “self-finance”), compared to those of potential competitors, may shield them so effectively that the country finds itself in a low-level governance trap — or “non-convergence trap”, in terms of catching-up growth and development, relative to the advanced countries (Acemoglu *et al.*, 2002) — that is all the more difficult to escape because it is embedded in the nation’s governance institutions.

As Bardhan (2002) thus explains, the “institutional arrangements of a society are often the outcome of strategic distributive conflicts among different social groups, and inequality in the distribution of power and resources can sometimes block the rearrangement of these institutions in ways that would have been conducive to overall development. [...] Even when the change would be Pareto-superior for all groups, collective action problems can be a serious hindrance”. These problems are recalled in Box V.2.

Box V.2. Collective Action Problems and Resistance to Change

First, the *free-rider problem*: an institution that everyone individually — and thus collectively — would like to see changed may persist simply because the costs incurred by the individual (or the coalition of individuals) initiating the change may outweigh the predicted benefits from the change for that individual (or coalition) alone, leading the potential initiator of change to give up unless a credible mechanism can be developed to ensure that other beneficiaries from the change will contribute to cover those costs at least up to the point where the initiator is not a net loser. Moreover, if the institution whose change or elimination is desired by the majority is nevertheless supported by a network of reciprocal social sanctions, individuals will conform to the institution out of fear that failure to do so would lead to a loss of reputation (see Akerlof, 1984).

Second, *potential losers may fear change and try (successfully) to resist it*: when the losses from change are certain and concentrated among a few individuals whereas the gains from change, though much larger in aggregate, are nevertheless uncertain for any given individual and diffused across society, the risk is considerable that strong resistance by potential losers will effectively hinder the change (Olson, 1965). Again, even if the gainers could find a mechanism to compensate the losers *ex post*, if they cannot credibly commit to do it, then compensation remains uncertain for potential losers, whereas they (the potential losers from change) know that by giving up the existing arrangement (or institution) there is a risk that they will not have the same “voice” in any future arrangement that they have in the existing one (Dixit and Londregan, 1995), making it likely that they refuse to co-operate and thus prevent change today.

Source: Adapted from Bardhan (2000).

Crony capitalism and its tendency to resist needed change thus squander a nation’s resources both because significant amounts are diverted to private ends and because many are consumed in the machinations of inter-factional competition. The mechanisms of resistance, widely reflected in excessive corporate resistance to change (of which the mechanics are often only barely visible), constitute the roots of durably *bad* corporate governance and low-level national governance “traps”. The building of tensions in society caused by such institutional rigidities and resistance to needed change tends also to produce episodes of violent instability (see Oman *et al.*, 2003).

Given the costs and risks associated with crony-governance systems, an important question is whether the strategy of regulating governance institutions by a public focal monopoly still serves as a model or reference for developing countries today?

What Future for the Public Focal Monopoly in Developing Countries?

If we refer to France's experience, some doubt is in order: by the 1970s, as we saw in Chapter IV, the governance culture inherited from the *Trente Glorieuses* increasingly appeared poorly adapted to domestic and international developments. These led to a decline in the attractive power of the focal monopoly (which was exposed to competition, fragmented and delegitimised) and reinforced inter-personal relations among private interests (an evolution illustrated in Figure V.2 by the arrowed-loop veering off toward the southwest, which occurred roughly and mainly in the 1980s).

What about developing countries? To judge from the remarkable developments in China, Chinese-Taipei, Singapore and Korea during recent years, it would appear that the strategy of focal monopoly must be re-assessed, even in those places where it has functioned well. Taking France and these countries together, three types of factors have undoubtedly contributed to diminishing the interest or likely effectiveness for currently developing countries to resort to the institutions of a public governance focal monopoly:

- 1) *The multiplication of focal points that potentially compete with national public institutions and risk destabilising it.* Globalisation and the opening of countries to international capital and trade flows have multiplied economic agents' options in their trade and investment operations. For large corporations that are key to the focal monopoly, the increase in the number and importance of suppliers, investors and clients no longer coming from the public sphere (e.g. foreigners) has correspondingly decreased their dependence on the public focal point, and thus their incentives to conform to the co-ordinating logic it imposes. The rising strength of international financial markets, itself due to a rapid increase in institutional investors, for the most part based in OECD countries, but acting as portfolio investors in "emerging" markets, has also given banks and companies in the latter an alternative source of external financing to public funds.
- 2) *The production and financing systems initially set up in the framework of national focal monopolies are reaching their limits.* Both the acceleration of technological change and increased competition due to trade liberalisation

have increased the size of investments firms must make (in R&D, technology, human capital, etc.) in order to be able to compete in global markets. While the external financing needs of public and private companies have grown rapidly, the traditional systems of public or para-public financing (often national development banks such as BNDES in Brazil or the development finance institutions in India) have slipped into crisis (debt crisis in Latin America and in Africa from the 1980s, balance of payments crisis in India (1990-91), etc.). The production system inherited from the focal monopoly – based on the promotion of national capitalists (large private groups, national champions, state-owned companies) and hinging on the selection and support of a limited number of investors, in industries typical of the second industrial revolution in countries at the height of a catch-up phase of industrialisation – was also very difficult to redeploy to achieve more “intensive”, i.e. *innovation-based*, growth.

- 3) *The reshaping of the interests involved in the focal monopoly*: While many new interests from civil society have asserted themselves through the democratisation process (workers, consumers, environmentalists, etc.), the traditional interests most involved, and indeed most deeply entrenched, in the functioning of public focal monopolies have often proved to be hugely resistant to change. The key reason for this resistance is found in the tangle of economic and political interests, and includes three issues:
- a) The financing needs of political parties, arising from democratic competition, paradoxically acted to reinforce the ties of dependency between the political and economic spheres;
 - b) The weight of large companies as national symbols and major employers meant that the fate and interests of political leaders were more and more linked to those of these companies, here again increasing the risk of clientelism, as was clearly the case with the *chaebols* in South Korea, the *keiretsus* in Japan or the public sector firms in France;
 - c) Finally, when elites make promises of shared economic growth the basis of their legitimacy, every lasting growth shock or visible increase in inequality seriously risks undermining their perceived legitimacy¹⁵.

Can one conclude that a development strategy based on a focal monopoly is less and less likely in the future to succeed? In its statist and centralised form, this conclusion is undoubtedly correct. The complexity of economic and

social interactions has become such that it no longer seems possible for these adequately to be assumed by any single actor, even one with the potential competence and scope of a state in a position of focal monopoly in its national territory. Nevertheless, the experiences and successes of this strategy allow us to draw lessons that may be helpful for the elaboration and, above all, the implementation of corporate governance policies in developing countries.

Going Forward

First, this study shows the extent to which the quality of corporate governance goes hand in hand with that of public governance. The proximity or overlap of the institutions of corporate and public governance is a feature of many countries, particularly those having followed a public focal monopoly development strategy.

These countries have succeeded — during the *Trente Glorieuses* in France, the 1960s to 1990s in East and Southeast Asia — in spectacularly *catching up* with the most advanced countries, notably the United States and, in the Asian context, Japan. The systems of corporate governance they put in place enabled the emergence and prevailing of a *general* interest, particularly among the elites, over the *potentially conflicting* private interests of diverse factions of society. All of this took place under the direction of powerful public institutions (this corresponds to a strategy of “turning to the east” in the two figures).

In contrast, countries that failed or succeeded significantly less in catching up were countries in which the institutions of corporate governance (and public governance) *did not manage to channel conflicts between factions of the elite sufficiently well to keep those conflicts from doing significant harm to the general interest* (e.g. Argentina). If their institutional arrangements did not allow a common interest to prevail, they had little chance of leading to sustained economic growth. The positive discrimination initiatives of the New Economic Policy in Malaysia from 1971 (reinforcing the economic capabilities of the *Bumiputra* — “the sons of the soil” — against the Chinese community) or of “Black Empowerment” in South Africa (aimed from 1994 at giving more power to the black community in governing companies) are clearly extreme cases. Yet, despite the difficulties these initiatives raise, they illustrate well the long-term unsustainability of manifestly exclusive (as opposed to inclusive) governance institutions [see the chapter on South Africa in Oman (2003)].

Taking account of the horizontal dimension (in our two figures) of governance cultures, i.e. taking *effective* account of the real — living and active — private interests anchored in a country's historic and human reality, and inducing them to march of their own accord in the direction of the general interest, enables the country to concentrate its efforts on feasible changes, thus multiplying their chances of success.

The successful governance experiences with public focal monopolies show that this mode of corporate governance has been particularly effective in *catching-up* growth processes (all the national growth “miracles” of recent economic history correspond to the phenomenon of catching-up growth). In a process of catching-up growth, a country's institutions of corporate and public governance need to give priority to a massive mobilisation and effective co-ordination of factors of production in the country (Rodrik, 1994).

Yet every *successful* process of catching up, by definition, reaches its limits. What happens then? Will systems of corporate governance that were effective yesterday remain so tomorrow? This question notably concerns such countries nearing the end of their catching-up processes as South Korea, Chinese-Taipei and Singapore, for example. Suffice it to consider France's experience over the last three decades to glean a preliminary answer: the nation's corporate-governance system, constructed around a public focal monopoly, has found itself surpassed by the rapidly growing complexity of the national economy — in a context of advanced trade and financial globalisation, of accelerating technological change, and of spectacularly intensifying competition.

A major challenge, still mostly unresolved, is thus laid before the country's institutions of corporate and public governance: that of *innovation*. By innovation, we of course mean technological innovation, but also financial and, above all, organisational and institutional innovation.

Indeed, in the world of today as we have sketched it, it is no longer possible simply to copy and adapt inventions made elsewhere, but it is increasingly necessary to take initiative oneself. As long as a nation is in the process of economic catch-up, firms can base their competitiveness on the mobilisation and co-ordination of factors. In the transition phase towards much more intensive growth that follows, the challenge of competition becomes that of increasing firm *productivity*, and thus, essentially, that of innovation¹⁶. At the organisational and institutional level, it requires a significant broadening of the scope and diversity of the interests brought into the necessary processes of consultation, negotiation, decision making and surveillance, and that those interests be given greater empowerment and autonomy.

Faced with such a challenge, corporate-governance systems cannot transform themselves from one day to the next. Yet this “stickiness” is no reason not to experiment with “transitional institutions”, however unconventional. What areas for action should be given priority? Priorities 1 and 2 mainly refer to the vertical axis of Figures V.1 and V.2 (increasing the level of systemic trust, power and information), and priorities 3 and 4 to their horizontal dimension (orienting the interaction of private interests towards the achievement of the general interest).

- 1) Significantly increase *informational efficiency*, i.e. the production of information (transparency) but also its quality, speed of circulation throughout the corporation, and accessibility to the outside environment, particularly for investors (disclosure). The responsiveness and competitiveness of companies depends on it. Responsibility for achieving it belongs collectively to a company’s internal governance mechanisms and the country’s stock-market regulators, banks and financial institutions, auditors, and the media.
- 2) Enhance the *empowerment* of individual public and private actors, and systematically make them *responsible* for the way they use this autonomy. In fact, numerous economic agents have acquired much *de facto* autonomy from the simple fact of a weakening focal monopoly. Yet this has often occurred without the obligatory counterpart of their having to report and answer for their actions (accountability). “Increasing the general level of courts and regulators [...], ensuring greater clarity in the legal rights of stakeholders [...], making board members, managers, and controlling shareholders directly [individually] liable for abuses against stakeholders” are among the basic steps supporting accountability (OECD, 2003b).
- 3) Encourage the emergence of effective *countervailing powers* in areas where hierarchic regulation previously acted to orient private interests in the direction of the general interest. These forces contribute through innovative behaviour (including political as well as economic “entrepreneurship”) and close institutional monitoring. Making non-government actors capable of defending their own interests should favour this objective by systematically reinforcing their capabilities. *Institutional investors*, in particular pension funds, might be especially effective because their involvement can, under certain conditions, greatly improve the quality of surveillance of corporate-governance institutions at relatively little cost to public-governance institutions¹⁷.

Other interest groups also stand to be highly affected by the transformation of corporate governance institutions, and should therefore involve themselves in the process: associations of minority shareholders first, but also creditors and local communities. Less settled is the question of the best form for labour-union participation to take, as an essential check, for the proper functioning of governance institutions¹⁸. Yet as far as *employee shareholders* are concerned, Frémond (2000) and OECD (2003b) point up the strong barriers they face in terms of corporate-governance participation. These obstacles may only be overcome if their access to information and to independent advice is strictly protected from insiders' actions, especially in the case of employee-ownership schemes invested in a pension fund.

- 4) In our long-term perspective, *the role of the state* must also be reconsidered. As Acemoglu *et al.* (2002) show, managerial selection becomes more and more important as an economy approaches the technology frontier (where most advanced economies lie). Otherwise there is a strong danger that asymmetries in resources among actors (e.g. information, power, capital, political connections) will prevent new actors (individuals and organisations) from effectively challenging incumbents, and thus prevent society from escaping a heavily factor-mobilisation-based approach to long-term development. As explained earlier, such low-level institutional or governance "traps" are also likely to be low-competitiveness traps because they impede a society's transition to a more strongly innovation-based economy.

To help in setting up a corporate-governance culture conducive to innovation, a state must evolve from a factor-mobilising and co-ordinating state to become the final guarantor of effective arbitration in confrontations between private interests that have been empowered and made accountable. Effective governance means above all that these confrontations do not undermine the attainment of the general interest. To this end, heavy penalties should be inflicted for all forms of illegitimate "self dealing" (Oman *et al.*, 2003), "tunneling" (Johnson *et al.*, 2000) or "hijacking" (Adelman, 2000). On this outcome will depend the efficacy, cost, fairness, and thus the sustainability, of whatever institutions of corporate governance prevail.

Such a transformation in the institutions of corporate governance does not imply a lesser role for public institutions, because even when a (provisional) institutional arrangement enables the collective interest to

prevail over private interest factions, such an arrangement is not a guarantee of durable stability. As our example of France during the *Trente Glorieuses* shows, it is precisely during periods of stability that coalitions of private interests organise themselves, or find new ways of doing so, for the purpose of increasing rents for their members at the expense of others — thereby also decreasing correspondingly the flexibility of the process of institutional change. This rigidity paradoxically increases a society's risk of volatility and also compromises the quality of subsequent transformations. Vivendi, Ahold, Enron, Parmalat and other hugely wasteful and costly recent corporate scandals remind us that even in the most advanced countries, achieving sound corporate governance is both a never-ending struggle, and inseparable from a country's institutions of public governance.

Notes

1. This framework is so named because it relies on the theory of contracts, property rights and agency theory. Corporate governance is summed up in this perspective by the following key question: in a world of incomplete contracts, how can residual control rights be efficiently allocated between investors and managers? For a synthesis, see Shleifer and Vishny (1997). Despite this model's great influence, it has also been criticised from within Anglo-American academic circles; see, for example, the work of Zingales (1997), Hodgson (1998), Blair and Roe (1999), Blair (2002) and Roe (2002).
2. According to the specific level and nature of governance in question, the common interest at stake will be that of a local community, company, region, country or even the global interest. A "common" interest (synonymous here with collective, public or general) at one level of governance could of course appear as a "particular" interest when seen from the perspective of the governance institutions at a higher "jurisdiction".
3. Dictatorships could exist on both the extreme left and the extreme right of the figure. This model could also be completed by adding a third dimension of governance cultures, which would reflect how democratic or dictatorial the political regime is.
4. This reasoning makes all the more sense for a country that possesses an administrative or state structure that is already reasonably robust (i.e. a country positioned in the southeast quadrant or close to the vertical axis in the southwest quadrant in the figure).
5. There are of course important differences between the regimes listed at the dates cited: they range from authoritarian regimes in the strict sense of the word (China, Chinese-Taipei, South Korea, France under Vichy) to democratically elected ones (Singapore and France after 1945).
6. Much of interest on this point can be found in the studies of South Africa, Brazil and India in Oman (2003).

7. Good examples are the case of Chinese federalism since 1978 and the success of Township-Village Enterprises (Qian and Weingast, 1997). How can one understand, for example, the formidable performance gap between the Chinese and Russian economies in the 1990s, when neither country had commendable corporate-governance institutions, secure financial markets, nor, more generally, institutions guaranteeing respect of property rights or the pre-eminence of the law? We return to the original alternative: either these institutions have no importance, or one must expand and modify the framework for analysis of institutional progress which hitherto has centred exclusively on the vertical dimension of improvements.
8. Social security in France since 1945, the support for the Korean rural population with the agrarian reform (Root, 1996), and the low-income housing policy adopted by Singapore in the 1960s (Lee Kuan Yew, 2000) are examples of such transfers.
9. In societies that remained very rural they also facilitated the diffusion of an ideal of national development fuelled by industrial growth and to which each individual should feel committed. Considering the functional requirements of the focal monopoly, this contribution was not insignificant.
10. There is still considerable evidence, however, that governance relations in these countries remain personalised, both in daily relations between public authorities and citizens and at the head of large companies, the civil service and the state.
11. In a sense, in referring to Figure V.2, one can say that Chile remained at the door of the lift (vertical arrow) until the start of the 1980s, not resolving to take advantage of it except following the shock of the economic crisis in 1982. The most beneficial reforms in terms of corporate governance date precisely from this period and deal with banking sector regulation (banning loans to affiliated parties, i.e. to members of the same group as the bank) and the introduction of a particularly well-structured pension fund system (see the chapter on Chile in Oman, 2003).
12. A notable exception in Brazil was the sector-wide agreement to open the automobile sector at the beginning of the 1990s (Schneider, 1997).
13. Our discussion of “crony capitalism” here owes much to Haber *et al.* (2002).
14. Examples of the first three types of “failures” are analysed in Haber (2002).
15. Two supplementary factors have certainly played a role in the power of elites to lead the population: first the power of example and the power to mobilise that leaders such as de Gaulle, Park Chung Lee or Lee Kuan Yew had, owing to their force of conviction, personal ethics and vision of national development, and their capacity to engrave this into institutions and to set up high quality administrations. Second, national traumas endured by all populations (including their elites) living during the 1950s to the 1970s in countries with a public focal monopoly, such as foreign occupation, civil war, and communist threat, created

a sense of cohesion that made them easier to mobilise. As new generations were born, these collective experiences, which had formerly served as strong mobilising forces, diminished in significance.

16. O'Sullivan (2000) and Lazonick and O'Sullivan (2000) provide valuable insight into the links between innovation and corporate governance. They first characterise the innovation process as being *cumulative, collective, and uncertain*. Focusing on the organisational capabilities of innovative firms in developed countries, they then derive detailed implications for innovation-supportive corporate governance. It has to fulfil three sets of requirements: *i) financial commitment* of resources to organisational learning and irreversible investments with uncertain results; *ii) organisational integration* of human and physical resources creating incentives for participants to commit their skills and efforts within the organisation; *iii) strategic control* vested with decision makers integrated in the learning process. "In combination, these three conditions support *organisational control* [as opposed to *market control*] over the critical inputs to the innovation process: knowledge and money" (Lazonick and O'Sullivan, 2000).
17. Institutional investors ready to commit themselves to long-term investments in the real economy — investors whose interests would be largely inclusive because their fiduciary obligations would lead them to diversify their portfolios to the point of internalising the externalities created by individual economic agents — should be able to constitute real checks and balances, on the condition that they are independent of corporate management and are subject to adequate prudential and judicial regulation. Particularly important for the future is the role of domestic pension funds (cf. Hawley and Williams, 2000; Davis and Steil, 2001; OECD, 2003b).
18. See, for example, the World Bank report by Aidt and Tzannatos (2002) underlining the positive impact of the negotiating power of unions in reducing inequalities and in improving the long-term performance of developing economies.

Annex 1

On the Determinants of France's Post-War Growth Rates

The best “growth-accounting” analysis of France’s remarkable post-war growth of national output and income, which averaged 5 per cent per year over the 19-year period from 1951 to 1969, attributes that growth to six (approximately) measurable sources of physical and human capital growth – six sources which together account for half of total growth – plus a statistical residual called “total factor productivity growth”.

Table A.1

	1951-1969 (% / year)
GDP	5.0
1. Working Stock	-0.1
2. Working Quality (age, education, intensity)	0.4
3. Professional Migration	0.6
4. Capital Volume	1.1
5. Capital Renewal	0.4
6. Demand Intensity	0.1
Residual	2.5

Source : Carré, Dubois and Malinvaud (1972).

With 2.5 per cent of France’s annual growth rate thus attributed to the “residual”, half of France’s post-war growth remains unexplained by the country’s ability to mobilise and accumulate both human and physical capital during that period. This high share of “unexplained” growth reflects the limits of the tools used in measuring and interpreting growth. A few methodological remarks are called for:

- 1) Growth-accounting analysis of this type is based on the assumption of a homogenous production function of the first degree (i.e. of the Cobb-Douglas type) and therefore does not take into account effects of *economies of scale*. These effects, which were relatively new to France, apparently had a significant diffusion effect throughout the structures of the national economy during this period. Aware of this limitation, Carré *et al.* have estimated the share of economies of scale at around 0.7 per cent, corresponding to a little more than one-quarter of the residual. Improvements in corporate management techniques, in particular, are thought largely due to economies of scale.
- 2) Measurements in this type of analysis of a nation's investment in physical capital (gross fixed capital formation) also do not take *intangible investments* into account. Yet France's investments in public research in the post-war period were considerable, making up for a century-old delay. With the advent of the Fifth Republic, gross R&D expenditure went from 1.1 to 2.4 per cent of GDP between 1958 and 1966. On average, 30 000 patents per year were submitted in the 1950s, increasing to 50 000 per year ten years later. In the same period, licensing expenditures were multiplied by five.
- 3) Investments in "*human capital*" appeared only very partially in the estimated improvements in labour productivity. These estimates did not take into account, for example, the very large distribution of social and medical services in society (public and private sectors).
- 4) The importance of *institutions*, particularly those of the state and para-public institutions and the quality of administrative personnel, is not sufficiently taken into account. Yet they weigh heavily on country performance.

In sum, to say that "total factor productivity growth" — as distinct from increases in particular factors of production — "explains" at least half of a country's growth comes down to admitting that the available tools and concepts only explain half of growth at best. Even if we could wait for significant advances in recent work on total factor productivity and the improvement of indicators on human and social capital, one must admit, as Carré *et al.* (1972) do in the conclusion of their work, that understanding long-term growth phenomena requires more than a "simple" economic growth-accounting treatment. The explanation of growth remains open.

Annex 2

Focal Monopoly, Governance Culture and Game Theory

Game Theory studies interactions between rational agents (or groups of agents). It allows us to model situations where an agent's gains (and thus incentives) not only depend on his individual behaviour in a given environment, but also on the behaviours of other "players" who may be pursuing different or even contradictory goals. One of the main insights of this theory is to show how difficult it is for players to co-ordinate their actions towards socially beneficial solutions if we assume that all players adhere to a strictly rational and individualistic pursuit of self interest.

Schelling (1960) updated Game Theory by showing that individuals put in a situation where they do not know how to choose rationally between two alternatives nonetheless have a co-ordinating capacity much greater than that previously predicted by Game Theory.

For example, imagine two people, each of whom must choose between two possible courses of action, which we can call "strategy A" and "strategy B". There are thus four possible outcomes, which can be shown in a "pay-off" or "outcome" matrix such as the one below. Choices are made simultaneously, so that players cannot make up their minds according to what the other has played. Player 1 chooses the line (A or B) in which he wants to play. Player 2 chooses the column (A or B) in which he wants to play. Each player discloses his or her strategy (A or B) without knowing what the other will play and they immediately get the pay-off corresponding to the outcome among the four possible outcomes (A,A; A,B; B,A or B,B). In each box of the matrix, the first figure corresponds to the gains of player 1, and the second to the gains of player 2. For instance, both players win 10 in boxes (A,A) and (B,B). In boxes (A,B) or (B,A), they both win -1, i.e. they both lose 1.

		Player 2	
		A	B
Player 1	A	10,10	-1,-1
	B	-1,-1	10,10

How do players choose their strategies? The answer depends on the information players have and on the hypotheses made about their behaviour. Do they know the rules of the game? Do they know the pay-off associated with each outcome? Does each player know whether other players have the same information as him? What does each player know about others' motivations? Are players rational and individualist? If yes, their calculation will then consist in comparing the private gains (or losses) associated with each strategy. These are some parameters on which Game Theory allows us to formulate hypotheses in order to determine under which conditions players may reach a collectively and/or individually desirable outcome.

At this point, we will simply assume that our two players know the rules and pay-offs of the game and know that the other has the same information. The two players are then in a situation of total indecisiveness: it is in their interest to co-ordinate on (A,A) or (B,B) which are two identical Nash equilibria (a Nash equilibrium is a situation wherein none of the players regrets his decision, given the other's choice). However, not knowing how the other will play, there is a one in two chance that they will end in one of the non-optimal solutions (A,B) or (B,A).

Schelling shows that in this situation, players have in fact more than a one in two chance of reaching an optimal solution. Schelling gives the following example: two people lost in a department store are looking for each other (they live in 1960, so they do not have a mobile phone). What should each do knowing that the other is asking himself the same question? Despite a totally unforeseen situation (unforeseen contingency), each individual will probably choose to look for the other around something "solid" or "salient" such as the entrance of the store or any other clearly visible location. As soon as we take into account *the decision context, a common history, institutions, etc.* a "focal point" is likely to appear.

Two important successors of Schelling focus on this point:

- 1) Lewis (1969) introduced the concept of *Common Knowledge* to Game Theory: in order to analyse player decisions, the entirety of their information and beliefs must be modelled. What they know (believe)

about the states of nature, but also what they know (or believe) about the other players, what they know (believe) that the other players know (believe), etc. *ad infinitum*. A “salience” recognised by all and providing a solution to the co-ordination problem (particularly when it arises repeatedly) is then called “convention” by Lewis. Such “common knowledge” information considerably helps reduce information asymmetries among players and facilitates their coordination.

- 2) Kreps (1990) defines *corporate culture* as the entirety of large reference points constructed by an organisation, having acquired a degree of objectivity and being able to act as spontaneous co-ordination reference point for unforeseen contingencies.

On the same basis, the study of a nation’s (or a corporation’s) *governance culture* could allow one or more functional focal points to be identified as sources of economic and social efficiency. In fact, Game Theory shows that individual decisions taken without reference to an institutional framework (traditions, relationships of trust or power, instances of dialogue, etc.) most often lead to wasted resources as soon as strategic interactions between players exist.

We can use this frame of reference in the “prisoner’s dilemma” or “battle of the sexes” models of games to describe situations of conflict between two interest groups.

Prisoner’s Dilemma: Two people suspected of a crime are arrested by the police and placed in separate cells. The police lack evidence on their real involvement, but a clever and Machiavellian inspector proposes the following deal to each:

Case 1: You denounce the other while he remains silent. Then we will make an arrangement with you so that you will be released while he will be sent to jail for eight years.

Case 2: You denounce each other, then you will both be sent to jail for five years.

Case 3: Both of you choose to remain silent, and then you will both just get short sentences, say one year for illegal possession of a firearm.

Obviously, the last solution represents the best outcome for the two. Yet, the most probable outcome is case 2 because both suspects will be afraid of being the silent one in case 1 while preferring to be the one reaching an agreement with the police. Consequently both end up being convicted for long sentences.

Let us formalise this game to see why case 3 is unlikely. Each player has the possibility of co-operating (C), i.e. remaining silent or of not co-operating (NC), i.e. denouncing the other. Player 1 compares his potential gains if he cooperates (line C: -1 and -8) with those obtained if he does not cooperate (line NC: 0 and -5). He thus chooses to play line NC in which gains are superior (or losses inferior) to those of line C, whatever the column chosen by player 2. With a similar reasoning, player 2 chooses column NC.

		Player 2	
		C	NC
Player 1	C	-1,-1	-8,0
	NC	0,-8	-5,-5

The result is that the only equilibrium is the situation of non co-operation (NC,NC) – the equilibrium of players’ dominant strategies – which is socially catastrophic since it incurs a total loss of 10. Interestingly, the situation of mutual cooperation (C,C) has no chance of occurrence if we hold to a strictly rational and individualist point of view, though it would be preferable for the two considered collectively (total loss limited to 2).

Battle of the Sexes: This game features a couple that wishes to meet in the evening (they do not have mobile phones either). The problem is that the man would like to go to a boxing match (B) while the woman would much prefer to go to the opera (O). The worst situation – box (O,B) paying (0,0) – is where both give in simultaneously so that the man goes to the opera while his wife goes to the boxing match. The situation where the couple is still separated but at least each can see what he or she prefers is a better outcome (payment: 1,1). Finally, the best cases are those in which one gives in but not the other (successful coordination).

		Woman	
		O	B
Man	O	2,3	0,0
	B	1,1	3,2

Governance Culture: Our hypothesis is that in France, and in a few other countries, notably in East Asia, during the second half of the 20th century, the state or institutions arising in and gravitating around the public sector played a role of focal point. Such institutions and behaviour saved these societies from disastrous confrontations between predatory interest groups (distributional cartels).

For example, in the “prisoner’s dilemma” case, the public powers could increase the gains of (C,C) to (1,1) (subsidies, public markets, soft loans...) or constrain the players by institutional means to play (C,C) (forced mergers, nationalisations...). The system of incentives and sanctions put in place by the Korean state in the 1960s to lead private groups to “play” exports is remarkable in this respect (see Amsden, 1997).

Another example illustrating the case of the “battle of the sexes” is that of attempted mergers and acquisitions between private groups. The public powers arbitrating these, for the most part, only served to ratify the existing power relations (Bauer and Cohen, 1985). As both protagonists know this fact, the weaker, not being able to rely on state support (except in particular cases), has no interest in insisting on the outcome that is individually most desirable; i.e. it would rather submit to the interest of the more powerful player and be happy with a moderate win or nothing at all and have to wait for the next opportunity.

The strength of the public or para-public focal monopoly is to make it so that the focal point of negotiations between interest groups is always within its sphere. This is such so that the protagonists are interested not only in what the other thinks or will do, but also at identifying the basis for a stable (unique) solution. If the focal monopoly is sufficiently strong, it will succeed so that *the collective level is taken into account by interest groups in developing their strategies* because negotiations have strong chances of passing, from one moment to the next, by the focal point placed somewhere in the orbit of the public sphere (see the quotation by Monnet (1976) in chapter III that proclaims this formulation exactly by Game Theory).

This focal monopoly worked with increasing effectiveness until the 1960s, facilitated by the context of strong growth. Players therefore had no reason to call into question a focal point that worked. But this focal point, only being an outcome of history, was not eternal and could unravel as it was made. Equally, if the “battle of the sexes” game began in 1950, the lady would without question have had an interest in going to the boxing match because this equilibrium had prevailed for generations. At the beginning of the 21st century, the situation is not so simple. Precisely, the public focal monopoly has lost some of its force of attraction since the 1970s, owing, among other factors, to having demonstrated its impotence, to the growing emancipation of private interest groups, and to the emergence of Europe and financial markets as competing focal points. In a long perspective, it nevertheless retains great significance for the transformation of a governance culture still marked by the weight of the state and, above all, for the analysis of possible reforms in all countries whose governance culture is, like France, historically distanced from the Anglo-Saxon culture of decentralised markets.

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