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# An Overview of Financial Systems' Diversity

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## Introduction

The analysis of the transformation of financial systems in developed countries has been the subject of many recent studies. Although a large diversity of financial systems was commonly observed, the central question became that of a hypothetical convergence towards the same model under various influences more or less linked to globalization. Going against commonly-held views, Schmidt, Hackethal and Tyrell (2002) show that the expected convergence of financial systems in Europe did not take place in the period prior to the introduction of the Euro. The question of diversity or convergence is not limited to the financial sector and the issue may be thought in a wider context of variety of capitalism (Hall and Soskice, 2001). The evolution of the financial sector would be a particular aspect of the transformation of economic systems that would lead all societies towards the model of a Liberal Market Economy (LME). The financial sector may have an important role to play in the transformation of these societies if one considers economic systems as a set of complementary institutions (Aoki, 2001). In this perspective, changes in the structure of financing and corporate governance of firms in Coordinated Market Economies (CME) could set off a series of transformations in other institutional areas and drastically modify the complementarities between institutions, leading former CME on the path towards the adoption of institutions characterizing LME. Such a 'sparking' role is sometimes attributed to the transformations affecting financial institutions in general and corporate governance in particular.

The issue of diversity, either among varieties of capitalism or financial systems, is often thought in dichotomous terms. One finds several dichotomies in the literature, which partly overlap with each other. Hicks (1974) distinguished two types of firms with differentiated financing needs: firms in the autonomy sector and firms in the overdraft sector. In the former, firms hold reserve financial assets; in the latter, they do not hold enough liquid assets and borrow, mainly from banks. A generalization of this dichotomy opposes financial markets-based to bank-based systems. This differentiation is not limited to the main source of firms' funding but also involves the relationship between the firm and its

financiers (Allen and Gale, 2000). Market-based systems are associated with arm's length finance, whereas bank-based systems may favor more or less long-term relationships, which may be instrumental in promoting cooperative behavior between the firm and its financiers and discourage morally hazardous behavior. Close relationships between banks and firms may help solving information-related problems, such as with the Japanese main bank system or with the German *Hausbank*. By contrast, financial markets are better at imposing a 'hard budget constraint' on firms and maintaining a commitment to refuse further funding to firms in case of default.<sup>1</sup> This may act as ex-ante incentives for the firm and prevent managers from investing in too risky projects; this bias may however not be socially optimal if it puts too high a 'short-termist' pressure on firms. Financial systems also share risks, and the most common view is probably that financial markets do a better job than banks in this respect, because they favor liquidity and reversibility of commitments for savers. However, Allen and Gale (2000) point out that financial markets also create risks through changes in assets value. Furthermore, some risks cannot be diversified at a given point in time, but averaged over time so that their impact on intertemporal welfare is reduced. Allen and Gale (2000) show that bank-based and financial markets-based systems have very different abilities at intertemporal risk smoothing. The former are much better as long as they are not under competitive pressure from the latter. Intertemporal risk-smoothing is much better provided by long-lived institutions accumulating reserves over time. But these intermediaries are fragile because individuals are likely to choose markets in good times, when the accumulation of reserves may not benefit them. Financial markets are on the other hand better at insuring against cross-sectional risks.

Countries also differ with respect to the type of corporate governance: whether managers have a strong incentive to act in the shareholders' interest (fiduciary duty), the channels through which shareholders monitor and influence managers, the type of election for the board of directors (whether it is one share one vote or not...), the number of external directors, etc. The market for corporate control, as a means of disciplining management and replacing it if the firm does not pursue a policy in the shareholders' interest, is more or less active according to countries. It may operate through various means, such as friendly mergers or hostile takeovers. The latter are more or less facilitated by the existing legal framework, which may authorise the implementation of various measures by the management in order to resist the takeover. Cross-shareholding for instance makes success of a takeover much more hazardous. Roe (1993)

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<sup>1</sup> Dewatripont and Maskin (1995).

showed how the US model of corporate governance emerged from a specific legal and law-making tradition prone to limiting the activities of banks under populist pressures, privileging managerial over workers rights, and taxing the dividends obtained from cross-holding of shares. This does not mean that US corporations are necessarily easy preys in takeover attempts. There are other ways to resist takeovers, such as minority shareholders protection and explicit anti-takeover rules. In most American states, corporate law allows the board of directors to fight off hostile takeovers. This is what Mayer (2001) calls a 'market control bias', by opposition to a 'private control bias' stemming from weak minority protection and leverage control devices such as in Germany: dual-class shares, pyramids<sup>2</sup> and non-voting shares allow dominant investors to retain control as outside ownership comes in. The legal framework in the US also privileged competition over coordination by specifying tight constraints on collaborative arrangements between firms in the same industry. In Germany and Japan on the other hand, different banking, labor, and competition regulations supported models of corporate governance that facilitated regular interactions between owners and managers and extensive collaborative ties between financial institutions and firms or between firms themselves.<sup>3</sup> Therefore, the principles of corporate governance are different on each side of the Atlantic and rest on different political economy equilibriums.<sup>4</sup> In the US, agency costs relative to the separation between management and ownership<sup>5</sup> are controlled by specific institutions and organizations: independent and active boards, incentive compensation of managers, an active market for corporate control, securities markets signaling from financial analysts, competitive capital and product markets etc. On the other hand, in most European countries, more rigid labor markets make it more difficult to lay-off workers, diminishing incentives for mergers and takeovers, boards are less active and effective, etc.

La Porta et al. (1997), (1998), (2000a, 2000b) have stressed the importance of legal determinants in the structure of financial systems and their differences across countries. Legal systems differ with respect to the extent of protection given to shareholders and creditors. This will have an impact on firms' financing, ownership structure and governance. They make a distinction between countries where common law predominates (the UK and the US for instance) from countries where civil law prevails (France, Germany and Scandinavian

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<sup>2</sup> Pyramids are structures in which a holding company controlled by an entrepreneur issues shares in a subsidiary that it itself controls.

<sup>3</sup> Roe (2001).

<sup>4</sup> Roe (2000).

<sup>5</sup> Berle and Means (1932).

countries). Civil law systems give weaker legal rights than common law systems, where shareholders and creditors' rights are stronger. However, the quality of enforcement of legal rules is highest in Scandinavian and German civil-law systems. An important point is that substitutes of legal protection have been developed in systems where there is more risk of appropriation by managers. There, investors require powerful mechanisms for exercising control through holding large ownership stakes in companies and exerting voting power that is disproportionate to the amount invested in firms. Concentrated ownership is a means to prevent the abuse of minority shareholders' rights when legal protection is weak, and acts as a monitoring device. Blockholders and private owners have means and motivation to monitor managers, dispersed shareholders in a 'Berle and Means' corporation have not. There is a free rider problem associated with dispersed ownership. No single shareholder has an incentive to incur costs for actively monitoring the firm. On the other hand, shareholders with a significant wealth commitment have such an incentive, so that the firm's value may increase with the concentration of ownership. Banks may play such a role, but there is a specific risk attached to this configuration. Acquiring information about the firm, banks may use it in order to extract rents. For Hellwig (1998), there is also a risk of collusion between banks and management, at the expense of outside owners. Blockholding may persist on the continent because managerial agency costs are potentially higher there and stockholders have no other alternatives to monitor managers. In countries where investors' rights are well protected, firms' ownership tends to be widely held whereas the reverse is true when investors' protection is low: shareholders control large blocks of shares, or companies are controlled by a single family or the state. On the other hand, a high level of creditors and shareholders rights favors the development of capital markets, which in turns fosters the dissemination of ownership. In addition, firms in common law countries pay more dividends than firms in civil law countries.

The present article does not aim at assessing all the changes taking place in financial systems and corporate governance in modern developed economies. It gives a broad overview of the diversity of systems and some indications of the current trends. The first section will treat the issue of diversity of systems from the point of view of funding sources. The next section will concentrate on the diversity of systems of governance, using the data gathered by La Porta et al. The third section will follow the inspiration of Roe (2003) and consider the links between financial systems, politics and political systems. The fourth section will conclude by presenting the recent evolution of financial systems in France and Germany.

## 1. Financing Structures of Non-Financial Firms

The differences between archetypal financial systems are sometimes mentioned in terms of the sources of financing of non financial firms. In the ideal market-based model, firms are supposed to benefit from an easy access to market finance and are expected to obtain most of their external financing from this supposedly cheaper source rather than from intermediated finance. On the other hand, underdevelopment of financial markets in bank-based systems prevent firms from having direct access to finance, hence, they must resort to bank credit as the main source of funds. The convergence hypothesis would then imply an increase in the share of direct finance in firms' funding pattern and a correlated decrease of intermediated funding.

Rajan and Zingales (1995) used (listed) firms' data and their results only partly confirmed common wisdom about the differences between market-based and bank-based systems. They showed that Germany, a typical bank-based financial system, was characterised by a low ratio debt/capital (0.20 in 1982; 0.16 in 1991) i.e. lower than the UK (resp. 0.19 and 0.24) or the US (0.29 and 0.37), which are market-based systems. Criticism addressed to Rajan and Zingales (1995)'s results concern the limitation to large listed firms in their sample. Other studies, including both large listed and small non listed companies in their sample deliver less clear results about the special position of Germany; the results of Rajan and Zingales may be due to a selection bias in their sample. Sauvé and Scheuer (1999) have shown that German SMEs are characterised by a strong share of bank credits in their funding, whereas larger firms tend to depend more upon their own internal sources of funds.

The source of funds may also be looked at using macroeconomic data from National accounts. The figures of Table 1 confirm a well-known result (Mayer, 1988), i.e. that the main source of non financial firms' funding is retained earnings, irrespective of the market-based or bank-based nature of the financial system. The sources of *net* financing of the non financial sector are computed from national accounts data, averaged over a period of over two decades. Several aspects may be mentioned. First, shares represent a small source of funds in all countries, and contribute negatively to firms' funding in countries that belong to the market-based club, i.e. the US and the UK. This negative contribution is usually due to firms buying back their own shares. Paradoxically, shares contribute the most in Italy, which is far from being considered as a market-based financial system. Second, retained earnings are the main funding source in all countries, and particularly in market-based countries. Third, bank credit is not a more significant source of funds in a bank-based country such as Germany, than in a market-based country, such as the United States, which confirms the results obtained with microeconomic data.

*Table 1: Net Financing Structure (%) of Non-Financial Firms*

	United States <sup>4</sup>	Japan <sup>4</sup>	Germany <sup>4</sup>	UK <sup>4</sup>	Italy <sup>4</sup>	France <sup>1</sup>	Netherlands <sup>2</sup>	Sweden <sup>3</sup>
Retained earnings	96,1	69,9	78,9	93,3	59,5	72,8	106,9	77
Shares	-7,6	3,5	0,1	-4,6	11,5	5,4	-6,2	-3
Bank credits	11,1	26,7	11,9	14,6	30,1	25,7	17,5	50,4
Bonds	15,4	4	-1	4,2	-3,4	3,2	0,7	-12,8
Other sources	-15	-4,1	10,1	-7,5	2,3	-7,1	-18,9	-11,6

Sources: United States, Japan, Germany, United Kingdom: Corbett and Jenkinson (1997), Italy: Cobham, Cosci and Mattesini (1999), France, Netherlands, Sweden: computations from OCDE National Accounts.

<sup>1</sup> 1970-1996

<sup>2</sup> 1985-1996

<sup>3</sup> 1980-1996

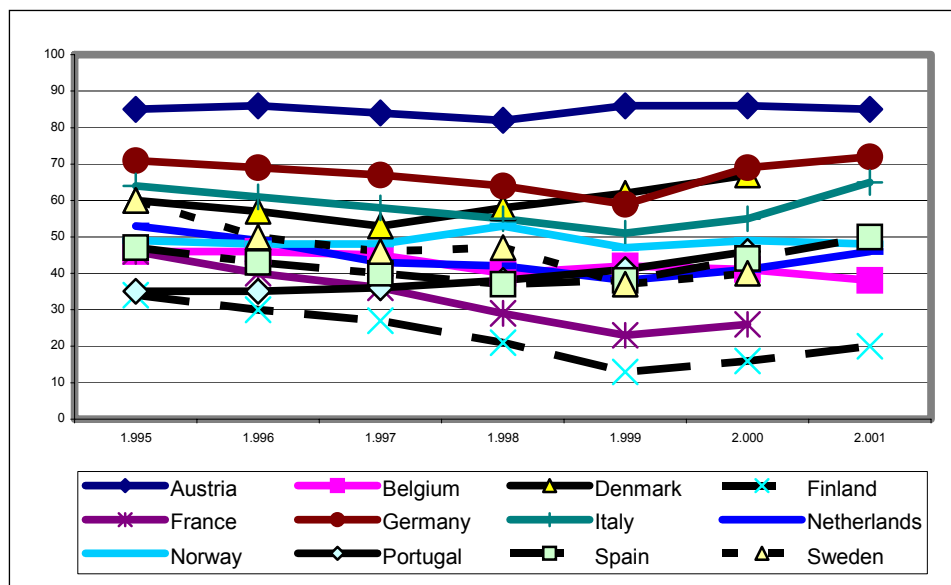
<sup>4</sup> 1970-1994

But this approach for assessing the respective weights of financing sources has been criticised by Hackethal and Schmidt (2004). Most comparative studies of financing pattern are based on net flows of funds. This method implies that new external funds such as bank loans are first used to repay any outstanding of the same financing source and that only the remainder makes a contribution to financing investment. This introduces a bias in favor of internal funds, which do not need to be repaid. They may thus come out as the most important financing source. Therefore, Hackethal and Schmidt argue that net flows are helpful in estimating the change in the importance of the various financing sources, but not the importance itself. Using gross flows instead of net flows, they show that long-term bank loans were the most important source of external financing in Germany and Japan between 1970 and 2000 (over 75% on average), whereas they represented only 18% of external funds in the USA for the same period. Their data does not support the hypothesis of a convergence of the German and Japanese financial systems towards the market-based system either. It thus seems that the difference between bank-based and market-based financial systems in financing patterns is still important.

We can have a look at this issue using a different data set. The data gathered by Capelle-Blancard and Couppey-Soubeyran (2003) concerns the most recent evolution of the financing structure of non financial firms: 1995-2001. They use the Eurostat National Accounts database and devise an intermediation ratio defined as the amount of credits divided by the sum of all *external* sources of funds of the agent (firm or public administration), i.e. credits and bonds. This ratio is thus computed from the point of view of the debtor and represents the

contribution of financial intermediaries to funding. Chart 1 shows this intermediation ratio for non financial firms.

*Chart 1: Intermediation Ratios for Non Financial Firms (%); Firms' Side*



*Source: Capelle-Blancard and Coupey-Soubeyran (2003).*

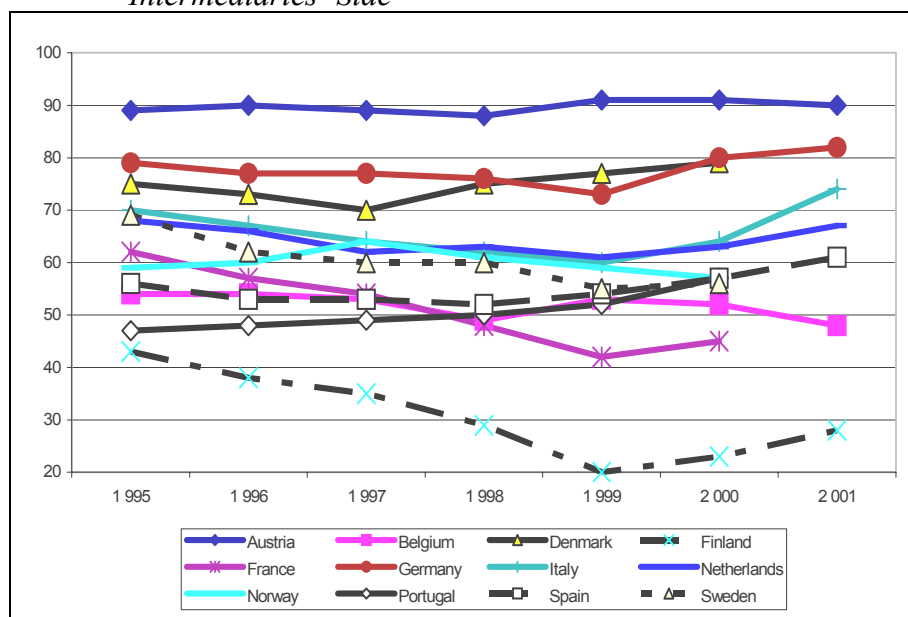
The evolutions pictured in Chart 1 do not suggest a general pattern of convergence towards the market-based model, provided one appreciates this convergence with the help of disintermediation. The role of financial intermediaries as the dominant source of funds was maintained in Austria, Denmark, Italy and Germany. On the other hand, some countries have seemingly experienced a pronounced disintermediation: Finland, France and Sweden. On average, Europe exhibits a moderate pattern of disintermediation, with Portugal being an exception since the share of financial intermediaries in firms' funding has actually increased over the period. Therefore, the feeling that there is a generalised and pronounced disintermediation underway is somewhat exaggerated. Capelle-Blancard and Coupey-Soubeyran (2003) show that disintermediation has much more affected public administrations than non financial firms. The intermediation ratio for public administrations dropped significantly in Belgium, Spain, France, the Netherlands, Austria and Sweden between 1995 and 2001. Indeed, in most European countries, financial markets liberalization was initiated by the State during the 1980s and furthered during the 1990s with a simple objective in mind: to allow public debt to find a wider



market and thus decrease the cost of public borrowing. Indeed, public bonds represent a significant share of all bonds traded on financial markets.

Disintermediation can also be assessed if one takes into account that financial intermediaries play also a role in the development of securities' markets. There is a complementarity between the role of intermediaries such as banks and the diversification of funding sources by firms. Intermediaries collect savings resources and channel them towards financial markets. Banks have also participated to the development of financial markets by buying securities and bonds. One may then devise another intermediation ratio that measures the activity of all financial intermediaries, which is no longer limited to supplying credit but also includes the purchase of securities. What was considered as direct finance in the computation of the ratio of Chart 1 is now reintegrated as intermediated finance. A second indicator of intermediation is defined as the ratio between the total of credits granted and securities detained by financial intermediaries on the one hand and the sum total of financial sources of funds of the agents on the other side. It adds to the intermediation ratio of Chart 1 the share of securities detained by financial intermediaries. This intermediation ratio is thus considered from the financial intermediaries' point of view. Chart 2 presents the figures for European countries.

*Chart 2: Intermediation Ratios for Non-Financial firms (%); Financial Intermediaries' Side*



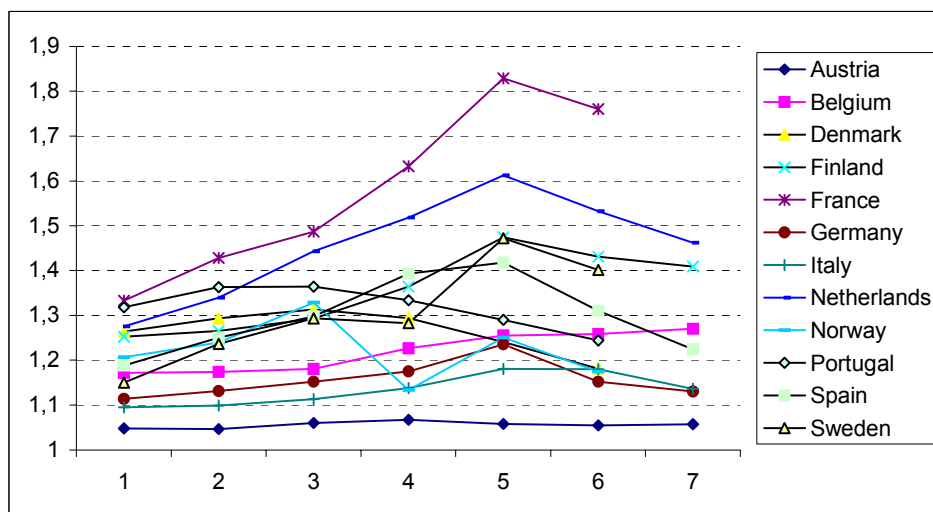
Source: Capelle-Blancard and Coupey-Soubeyran (2003).

As expected, the intermediation ratios are now larger when one takes into

account securities held by intermediaries. The reintegration of financial intermediation does not alter too much the picture obtained with the figures of Chart 1. There is a limited decrease in the intermediation ratios on average; some countries maintain or augment their intermediation ratios: Austria, Denmark, Germany, Portugal, Spain and a few countries experience a decrease: Finland and France in particular.

The difference between the two intermediation ratios may be interpreted as the 'market finance' or non traditional activity of financial intermediaries, i.e. purchase of bonds instead of credit supply. Chart 3 gives the ratio between the two intermediation ratios considered in Chart 1 and 2, i.e. the ratio between the financial intermediaries' side and firms' side intermediation ratios. Chart 1 shows that the situation of European countries is indeed very diverse. Financial intermediaries have kept their more traditional role of credit suppliers to non financial firms in Austria, Germany, Italy and Norway, but seem to have significantly reoriented their activity in France, the Netherlands, Finland and Sweden.

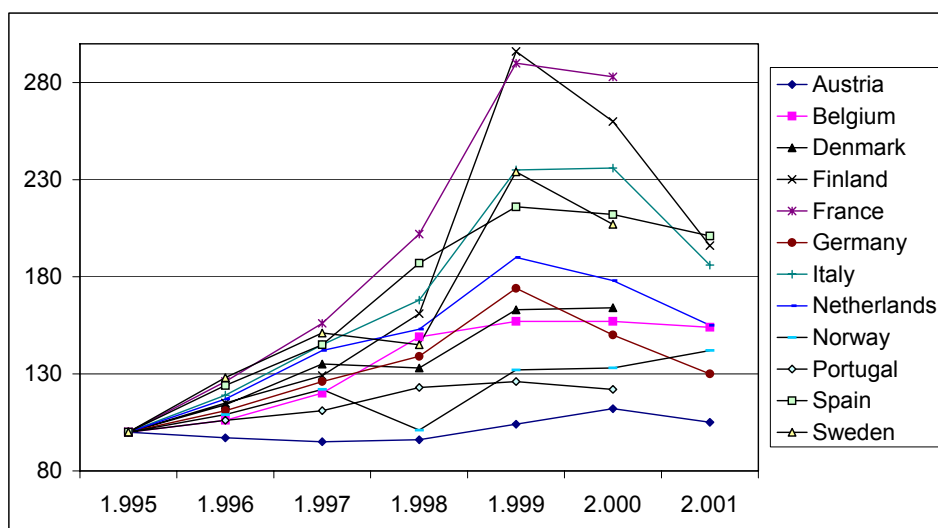
*Chart 3: Relative Size of Market Finance Activity of Financial Intermediaries*



There is a problem linked to the use of intermediation ratios above. They account for the rise in the value of securities, particularly shares. Therefore, two effects are mixed: the increase in the number of shares issued to the public and the rise in the value of shares. Only the first effect actually reflects the growing contribution of disintermediated finance to firms' funding. The increase in

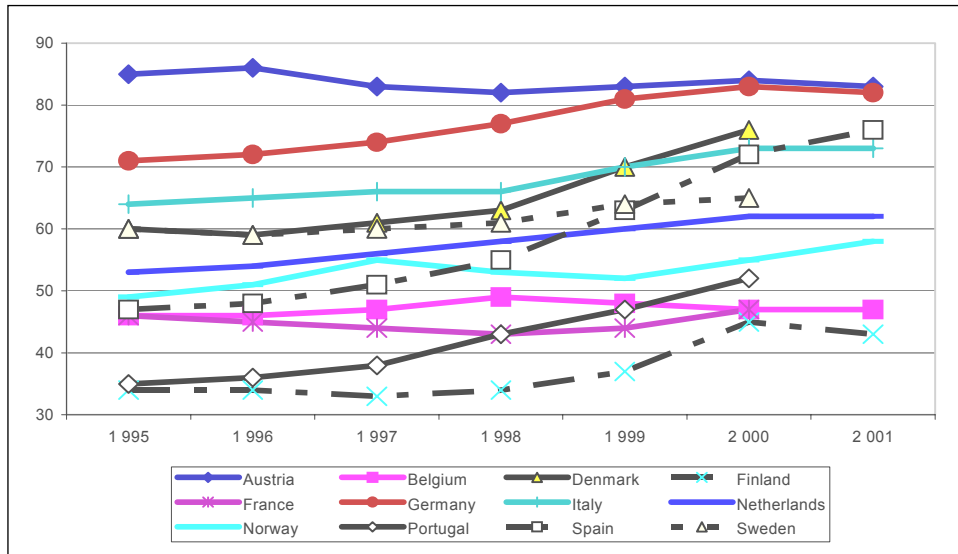
shares' prices, particularly pronounced for the period under consideration, artificially increases the contribution of securities to funding. Capelle-Blancard and Couppey-Soubeyran (2003) propose a deflator for shares' prices, which takes into account both listed and non listed shares. The evolution of the deflator for European countries is shown in Chart 4. An important feature is that there is a non negligible degree of heterogeneity among countries; France, Finland, Spain and Sweden are characterised by high shares prices, in opposition to Austria, Portugal, Germany or Norway. Such differences are bound to distort the evaluation of disintermediation, by an overvaluation the contribution of shares.

*Chart 4: Deflator for Shares' Prices; 1995=100*



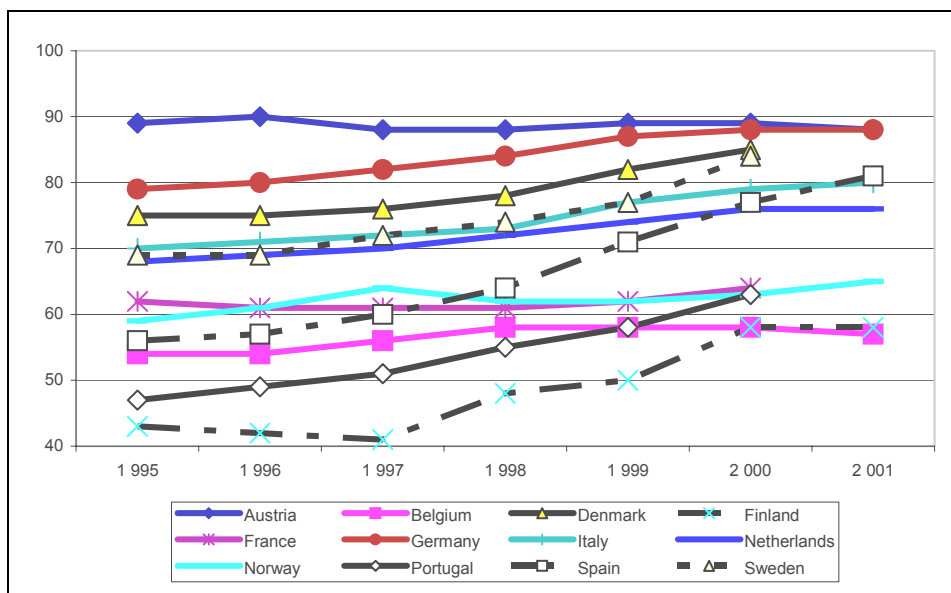
The deflated intermediation ratios are presented in Charts 5 (firms' side) and 6 (intermediaries' side). The result is that disintermediation vanishes: on average, the ratio has increased between 1995 and 2001, whether one considers the firms' or the financial intermediaries' point of view. The case of countries which had seemingly experienced the more pronounced disintermediation is exemplary. France maintains its intermediation ratio, and Finland actually sees it rising. Therefore, the disintermediation trend observed above is almost entirely due to the rise in shares prices.

Chart 5: Deflated Intermediation Ratios for Non-Financial firms (%); Firms' Side



Source: Capelle-Blancard and Coupey-Soubeyran (2003).

Chart 6: *Deflated Intermediation Ratios for Non-Financial Firms (%); Financial Intermediaries' Side*



Source: Capelle-Blancard and Coupey-Soubeyran (2003).

Nevertheless, this does not mean that nothing has changed over the period in the structure of intermediation. One can compute the shares of different intermediaries: banks, other intermediaries, and insurance companies and pension funds. The share of insurance companies and pension funds in the source of funds of non financial agents has increased in all countries except in Denmark, Portugal and Germany, even when one takes into account the shares prices deflator. They represent between 2% (Austria) and 14% (Netherlands) of non financial agents' funding sources. On the other hand, banks have seen their share of funding decrease in all countries except Denmark, Portugal and Sweden. They represent between 27% (Finland) and 66% (Germany) of non financial agents' sources of funds. However, the differences in contributions to funding have not varied much over the period.

## 2. Control

The traditional dichotomy of financial systems may have more sense when one

considers the pattern of control and the implications for corporate governance. An external control characterises market-based system whereas an internal control applies in bank-based systems. In the former, stock markets are developed enough for the firms to be able to have access to direct finance. Ownership diffusion discourages share owners to incur active monitoring costs because of the public good aspect of monitoring. Since no direct monitoring is exerted, external control applies, through the threat of share sales or other indirect mechanisms such as takeovers. In bank-based systems on the other hand, ownership concentration and blockholding allows for a closer, internal type of monitoring. The risk is then for minority shareholders, who are too small to monitor, to suffer from a possible collusion between blockholders and managers.

We can try to assess the diversity of countries with respect to control by using various indicators. La Porta et al. (1997), (1998), (2000a, 2000b) have proposed a set of indicators concerning control and corporate governance for a large set of countries. Their data apply to the mid-1990s and concern the size of the stock market, which conditions the possibility for the emergence of an external control, the structure of ownership of listed firms and the diffusion of ownership. Some other variables characterising the structure of financial systems are also considered as supplementary variable, i.e. not contributing to defining the factorial axes.

We apply a principal components analysis to the control indicators for 18 developed countries. The projection of countries in the first factorial plane is given in Chart 7. The first factor accounts for 45% of the variance alone. The variables defining this factor or significantly associated to it are the following.

- On the negative side: stock market capitalization to GNP (and external capitalization to GNP); widely held character of the ownership of large listed firms; the ratio of financial investors' assets to GDP; the percentage of shares in the portfolio of institutional investors; the merger and acquisition activity; the quality of accounting standards; the size of venture capital investment;
- On the positive side: various measures of ownership concentration such as the fraction of the firm's voting rights owned by its controlling shareholder or the fraction of the firm's ultimate cash-flow rights owned by its controlling shareholder; the scope of public enterprises' sector, the size of public ownership of firms; the control of large firms by families; the percentage of bonds in the portfolio of institutional investors.

This factor is clearly the one opposing internal (positive side) to external (negative side) control. The association of variables such as diffusion of ownership and size of the stock market on the same side is a confirmation of the mechanisms invoked for the functioning of an external control. Also, the size of

the State's intervention is negatively associated to financial markets' development and appears positively correlated on the positive side of the axis.

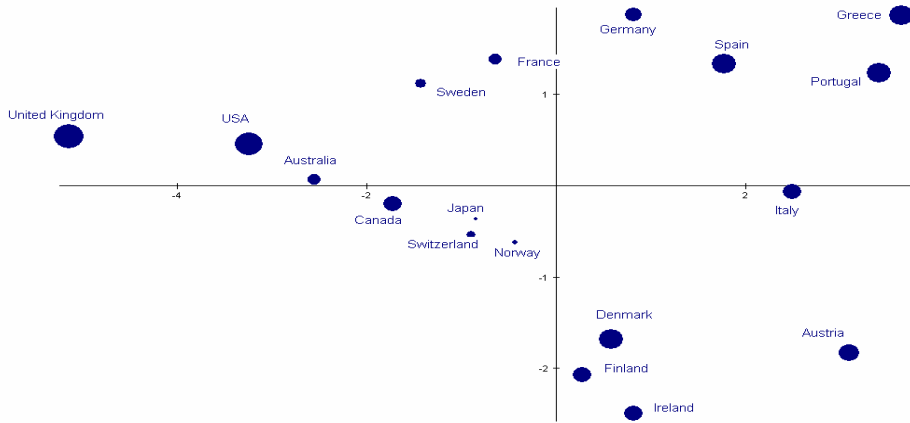
The first factor clearly separates market-based countries such as the UK or the USA from countries such as Greece, Portugal, Italy, Austria or Spain. If describing correctly a simple opposition between internal and external control, this factor only partly reflects the traditional opposition between bank-based versus market-based systems: some of the most archetypal bank-based countries (Japan and Germany) are found somewhere in the middle on the first axis, where most Continental European countries are also located.

The second factor accounts for 15% of the variance. The variables defining this factor or significantly associated to it are the following.

On the positive side: Control of large firms by pension funds, mutual funds and miscellaneous financial corporations, the quality of enforcement and transparency, concentration of the banking sector

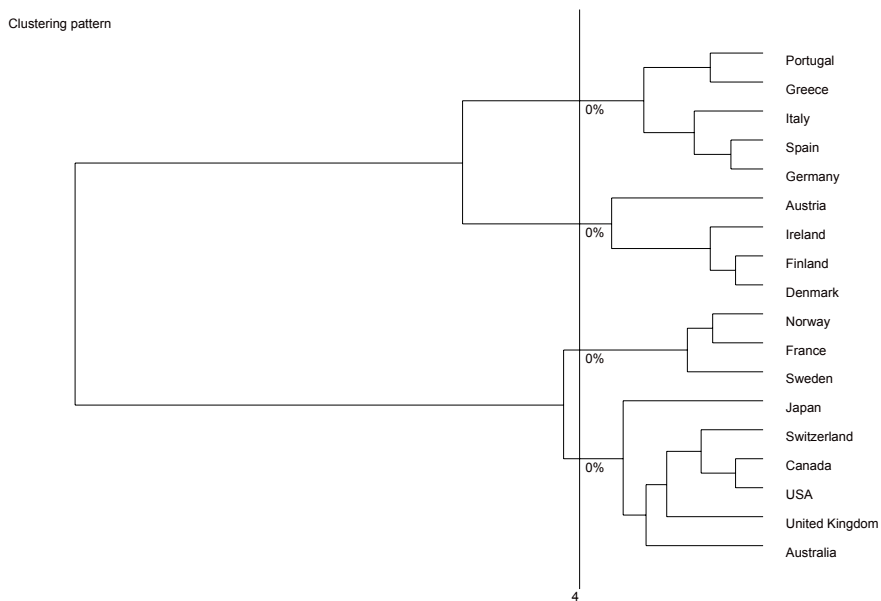
This axis is less easily interpretable in terms of external versus internal control. It separates some North European countries from Greece and Spain. This factor also suggests that the quality of enforcement and transparency is partly independent of the diffusion of ownership and the development of stock markets.

Chart 7: Projection of Countries on the First Factorial Plane



One can use these results to identify clusters of countries. The clustering pattern is given in Chart 8.

Chart 8: Country Clusters





One can distinguish four clusters of countries:

1. USA, Canada, UK, Switzerland, Australia and Japan. This cluster is characterised by a high level of protection of shareholders' rights, a wide diffusion of firms' ownership, developed stock markets and a substantial investment of institutional investors in the stock market. Also, public ownership is lower than average.
2. France, Norway and Sweden. Countries of this cluster are characterised by a larger than average control of firms by financial institutions.
3. Ireland, Denmark, Finland and Austria. This cluster is characterised by a relatively low importance of family control.
4. Germany, Spain, Italy, Portugal and Greece. This cluster is characterised by ownership concentration, a certain lack of conformity to international accounting standards, a low mergers and acquisition activity and a moderate development of stock markets.

Interpreted in terms of the opposition between insider and outsider systems, the clustering pattern described above distinguishes a group of outsider control countries (cluster 1) from two groups of insider control countries (clusters 3 and 4), while cluster 2 seems to occupy an intermediate position. Only the presence of Japan is a surprising element in the list of countries belonging to cluster 1, but the position of this country in the first factorial plane (Chart 3) and the clustering tree (Chart 4) somewhat distinguishes it from the core group of outsider control countries (USA, Canada, the UK and Australia). Clusters 3 and 4 represent two groups of insider control countries, the former being intermediate between cluster 1 and cluster 4. Countries of the fourth cluster are nearer to the traditional representation of outsider control (underdeveloped financial markets, important role of banks...) than countries of cluster 3 and even more cluster 2. The average intermediation ratio (calculated from section 1) is higher in the former group than in the latter. Also, stock markets have been growing quite importantly in some countries of cluster 2: in 2000, the ratio between the number of listed firms and the population was 32.3 in the UK (cluster 1), 13.4 in France (cluster 2) 9.1 in Germany and 5.0 in Italy (cluster 4).

### 3. Politics

To establish that there is some diversity in systems of financial intermediation and corporate control does not explain what is behind this institutional diversity. La Porta et al. have ventured that differences in legal systems explain the type

and extent of investor protection, hence the incentives to invest in shares and more generally the type of financial system of a country. The explanations for differentiated patterns of development of stock markets and the type of corporate governance would then find their roots in history, i.e. in legal traditions which have been established centuries ago. La Porta et al. distinguish four types of legal tradition: Anglo-Saxon (common law), French, German and Scandinavian (civil law). The Anglo-Saxon legal tradition is held to protect investors the best, whereas the French tradition is supposed to provide the weakest protection. Is a partition of countries according to legal tradition compatible with our results concerning corporate control? Crossing our clustering pattern with legal traditions gives the results presented in Table 2.

*Table 2: Percentage of Countries in Each Cluster According to Legal Traditions*

%	Cluster 1	Cluster 2	Cluster 3	Cluster 4
Anglo-Saxon	66.7	0.0	25.0	0.0
French	0.0	33.3	0.0	80.0
German	33.3	0.0	25.0	20.0
Scandinavian	0.0	66.7	50	0.0

The correspondence between legal traditions and types of systems is broadly consistent with La Porta et al.'s position: countries of cluster 1 come mainly from an Anglo-Saxon legal tradition, i.e. the one that provides the most extensive investor protection, whereas countries from cluster 4 belong mostly to the French legal tradition. However, the correlation is not perfect as can be seen from the legal origins of countries of the other two clusters.

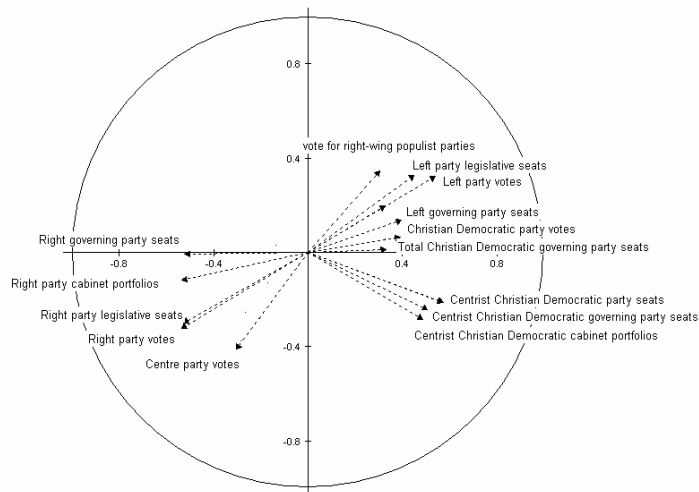
Pagano and Volpin (2001) and Roe (2003) have proposed other determinants of systems of corporate governance. Roe argues that political forces account for the differences in choices of financial systems and systems of corporate governance. Roe's argument can again be specified in a binary opposition. Social democracy would be associated with weak shareholder rights and hence a low diffusion of ownership. The mechanisms involved are that social democracy gives rights to stakeholders as well as shareholders: employment security, income distribution, welfare... Blockholders can partly counter these claims whereas a dispersed ownership could not. A consequence is that partizan politics in terms of left versus right should be strongly associated with differentiated financial systems. Gourevitch (2003) proposes supplementary political arguments related to the differentiation of corporate governance systems, widening the channels of political mechanisms at work and opening new possibilities of interest group expressions beyond the left/right divide. Interest groups could coalesce on a cross-class rather than class divide. Besides,

institutional mechanisms of interest aggregation are likely to matter too; political institutions themselves will affect the pattern of coalition formation.

We can attempt at checking the relevance of these points by looking at the correspondence between the classification of countries obtained in the previous section, which is partly understandable in terms of diffused versus concentrated ownership as well as insider versus outsider control, and variables expressing partizan politics as well as political systems of the various countries.

For partizan politics, Swank (2002)'s pooled time-series data base on political parties and election results will be used. The data covers the period between 1950 and 1999 for all the countries of the sample used in the preceding section and provides information on cabinet portfolio compositions, percentage of legislative seats and percentage of votes of the major political orientations: left-libertarian, left, right, centre, Christian-democratic, and right-wing populist parties. Only averages over the 1989-1999 period will be considered here. In order to check the correlations between partisan politics and financial systems, we project the various indicators on the factorial space we came to in the characterization of the financial systems. Therefore, the first factor more or less reflects an opposition between concentrated and diffuse ownership, and the second factor accounts for concentration of the banking sector, the quality of transparency, and distortion of the one share one vote rule.

Chart 9 shows the projection of political variables. Roe's predictions are partly confirmed. The first axis can also be interpreted as a right/left axis. On the side of diffuse ownership (Anglo-Saxon countries and Japan), one finds variables such as the percentage of votes for right-wing parties, whereas votes for the left are on the side of concentrated ownership. But this latter type of ownership is not only associated with left political forces. Centrist and Christian Democratic parties votes can also support the type of corporatist arrangements that Roe (2003) associated with Social Democracy. Votes for left-libertarian or right-wing populist parties are not so well associated with one or the other type of corporate governance system.

*Chart 9: Projection of Political Variables on the First Factorial Plane*

In order to account for the diversity in political systems, we use two types of databases. Lijphart (1999) distinguishes between majoritarian and consensus based systems. The idealised majoritarian system is the ‘Westminster’ model of democracy defined by Lijphart (1999) as having ten characteristics. (1) The executive is concentrated in single-party cabinets. (2) Cabinets dominate the Parliament. (3) There is a two-party system. (4) The electoral system is majoritarian and disproportional, majorities are ‘manufactured majorities’ created by the electoral system out of mere plurality of the votes. It is possible for one party to win without a majority in votes. (5) The interest group system is pluralist, i.e. a multiplicity of interest groups exerts pressure on the government in an uncoordinated and competitive manner. Unions or management are not integrated in the policymaking process and both sides settle their differences in a confrontational manner. (6) There is a unitary and centralised government, as opposed to federalism. (7) Legislative power is concentrated in a unicameral parliament. (8) Constitutions are flexible. (9) There is no judicial review, i.e. no written constitutional document with the status of ‘higher law’ against which Courts can test the constitutionality of legislation. (10) The Central Bank is controlled by the executive. The majoritarian system is best exemplified by the United Kingdom.

The consensus model by contrast is based on bargaining between organised interest groups. Those affected by a decision have a chance to participate in the making of that decision. The almost pure model of consensus democracy is given by Switzerland: (1) The executive power is shared in broad coalition cabinets. (2) There is a balance of power between the executive and the

legislative. (3) There is a multiparty system, reflecting a multiplicity of cleavages in the society. (4) Electoral systems are organised around a proportional representation. (5) Interest representation is based on corporatism, either social corporatism where labor unions dominate, or liberal corporatism in which business associations are the strongest force. (6) Government is federalist and decentralised. (7) The Parliament is constituted of two chambers, enabling a special representation of minorities such as the smaller states in a federal system in the second chamber. (8) Constitutions are rigid. (9) There is judicial review. (10) The Central Bank is independent.

Both models will differ with respect to the number of 'veto points' and the weight of 'veto players'.<sup>6</sup> Veto points are any point within the political system where a policy measure, legislation or any institutional change may be blocked and the status quo preserved; veto players are individual or collective actors who may block such measures. Where a veto may be opposed and who may do it depends on existing political institutions. The consensus-based model is likely to have more veto players than the majoritarian model. As a consequence, the latter system will more easily enable radical institutional change once political change has brought a new government into power. The former system is likely to be much more resistant to radical institutional change and permit a better representation of organized, corporatist interests

Lijphart (1999) has proposed a certain number of indicators characterizing political systems, distinguishing between. Some of them are particularly relevant for stressing the differences between the political systems underlying the different models of capitalism:<sup>7</sup>

- The number of issue dimensions addressed by political party programs. A large number of political parties allow for the expression of a highly differentiated political demand, which may reflect the strong positions gained by particular socio-political groups. The dimensions of political conflict should increase with the number of parties. A two-party system must have a political platform of the 'catch-all' type, which aims at the median voter and where parties cannot afford to confront specific interest groups on well defined issues.
- The degree of disproportionality of the electoral system. The typical electoral system of majoritarian democracy is the single-member district plurality or majority system; consensus democracy uses proportional representation. Single-member districts favor the emergence of a winner-take-all system.

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<sup>6</sup> Tsebelis (1995, 2002), Scharpf (2000).

<sup>7</sup> See also Gourevitch and Hawes (2002) and Amable (2003) for the relation between political variables and types of capitalism.

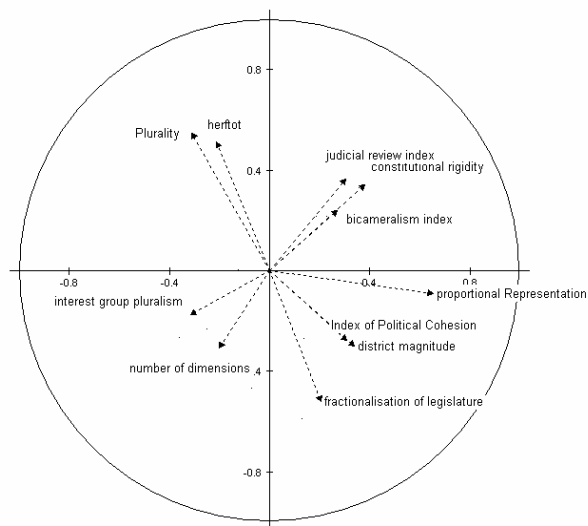
The index of disproportionality gives an indication of the aggregate vote share/seat share deviation.

- Interest group pluralism. The typical interest group system of majoritarian democracy is a competitive and uncoordinated pluralism of independent groups in contrast with the coordinated and compromise-oriented system of corporatism. This indicator can be interpreted as an anticorporatism index. One should then expect to see market-based economies associated with high values of the three indicators, whereas Continental European and Social-Democratic economies should exhibit low values of these indicators.
- Constitutional rigidity. Presence or absence of explicit restraints on the legislative power of parliamentary majorities. Is the parliament the supreme law-maker or is there a constitution serving as a higher law. Distinction between flexible constitutions (changed by a majority) and rigid constitutions (supermajority). Based on the case of the UK, one would expect market-based economies to have non rigid constitutions, but this is not so clear if one considers the case of the US.

Other indicators may also be taken into account. The database of political institutions of the World Bank Beck, Clarke, Groff, Keefer and Walsh (1999) allows considering the following:

- An indicator of political parties concentration, the Herfindahl index, i.e. the sum of the squared seat shares of all parties in the government and the opposition in the lower chamber. If market-based economies rest on a two-party-median-voter system, they should have a higher political concentration than other types.
- Fractionalization of legislature. It is the probability that two deputies picked at random from the legislature will be of different parties. Here again, this indicator should split the market-base economies from the other types, particularly the social-democratic model.

*Chart 10: Projection of Political System Variables on the First Factorial Plane*



The projection of variables shown in Chart 10 indicate that political systems variables are indeed associated with some dimensions of differentiation of corporate governance systems, but not so much with the first axis, i.e. the factor of ownership diffusion, but with the second axis. The variables reflecting a majoritarian system are associated with the negative side of the second factor, whereas the consensus-based model is on the positive side of the same factor. Only proportional representation (a variable reflecting the consensus-based system) points towards the side of concentrated ownership. These findings can be seen as a confirmation of a point made by Roe (2003) against La Porta et al. Some countries may have a good quality of corporate governance (the quality of enforcement transparency is on the positive side of the second factor) and yet have some degree of ownership concentration. But this latter aspect is not enough if one does not take also into account variables of interest representation characterizing the consensus-based model. Therefore, good corporate governance could be obtained in a system with concentrated ownership *and* a consensus-based model of interest representation that would ensure that all interests, including those of minority shareholders, are sufficiently well represented.

## 4. Evolution of Systems

The financial systems of most European countries have experienced significant changes during the past few years. The common trends are an increase in stock market capitalization and the number of listed companies, a decrease of state ownership, an increasing role of foreign ownership, and particularly extra – European (mostly American) institutional investors and a diffusion of financial markets-based criteria of corporate governance. These changes are complementary with changes affecting other areas and institutions: employment and product market regulation, welfare systems... and the context is that of a possible convergence towards a market-based model of capitalism or an LME.<sup>8</sup> Part of these complementarities are understood at the EU level: the Green paper of 1997 on Supplementary Pensions in the Single Market mentioned a virtuous circle of increasing funding of supplementary pensions into European capital markets which would in turn set in motion an increased securitization leading to a deepening of financial markets. The dynamics would thus link an increasing share of private social insurance scheme to a rise in the role of financial markets. This factor has played a major role in the transformation of the Swedish system of corporate governance for instance, (Henrekson and Jakobsson, 2003).

We can concentrate on the cases of France and Germany to illustrate the changes taking place at the beginning of the years 2000 in Continental European systems. Both, France and Germany experienced changes in the regulative framework of the banking industry and the soar of financial markets. The main reforms affecting French banks were undertaken in the 1980s, with the 1984 Banking Act putting an end to the regime of different interest rates, the creation of a futures market in 1986 and the liberalization of the stock exchange in 1988. After 1986, most public banks were privatized in several waves. By contrast, public banks still represent over a third of the market share in Germany and local *Landesbanks* are backed by public guarantee. The stock exchange was reorganised during the 1990s and transformed into a publicly traded company (Deutsche Börse AG). Some additional transformations were necessary to harmonise German law with international norms as well as EU Directives. A series of financial market promotion acts were passed, introducing a secondary capital market, increasing transparency, protecting small investors and allowing more types of investment funds, and making gains from risk capital tax-free after one year instead of six. An independent authority for securities trading supervision was established. A new stock market for fast growing firms, *the*

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<sup>8</sup> Amable (2003).



*Neue Markt* was created at the Frankfurt stock exchange.

One of the main drivers of change in the French financial sector was the privatization of a substantial amount of French industry all through the 1980s and 1990s which mechanically 'deepened' existing financial markets. Moreover, in order to obtain better conditions for its public debt, the State initiated a process of financial liberalization that led to a surge of direct instead of intermediated finance. In both countries, the development of financial markets contributed to loosening the ties between firms and banks. The former tried to diversify their investor base while the latter aimed at redirecting their activities away from direct participation and toward financial services such as securities trading and business consultancy, or tightening their links with the insurance sector. The evolution of bank asset structures clearly shows the rise of these activities at the expense of the more traditional loan activity in France. This evolution also takes the form of the creation of subsidiaries dedicated to investment banking and/or insurance.

Firms internationalized their investor base and had to comply with international accounting rules in order to be listed on foreign stock exchanges such as the NYSE. A consequence of investor diversification was a growing importance of market finance under the guise of institutional investors, particularly foreign Anglo-Saxon institutional investors who had special requirements in terms of corporate governance. In both countries, new laws were passed in 1998 to authorize firms' shares buyback up to a limit of 10%. This enabled firms to put into practice stock option plans in order to supply high-powered incentives to the top management as well as boost share prices making them more attractive on the stock market. In general, managerial behavior had to reorient towards a policy of shareholder value: improving the informational quality of annual reports, which involves among other things a change in the accounting rules to international or American standards. Höpner (2001) reports that the orientation of large German companies toward a policy of shareholder value since the mid-1990s is indeed linked to the rise of institutional investors as shareholders. Nevertheless, the German Company Law explicitly denies the role of shareholders' agent to the management. The fiduciary duties are due to the firm itself, not to any particular group.<sup>9</sup>

The transformation of Continental European countries may be assessed with an indicator of conformity to corporate governance practices proposed by Shinn (2001). Seven points are taken into account:

- Accounting systems; coded 1 if a majority of the listed firms use GAAP or

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<sup>9</sup> See Pistor et al. (2001) for a comparison of company laws. Also, the supervisory board must act independently from any specific stakeholder in the Netherlands.

IAS in their reporting or when the country's domestic accounting system differs only slightly from IAS.

- Audit; coded 1 if third-party audit is a listing requirement.
- the presence of non executive directors on board (average percentage): coded 1 if majority
- the existence of fiduciary duty;; coded 1 if directors' liability to minority shareholders has been enforced in courts on the basis of derivative or class-action suits.
- voting rights rules; coded 1 when 'one share one vote' is observed in practice, in terms of statutory rights and procedures.
- anti takeover provisions; coded 0 if listed firms employ significant anti-takeover provisions
- management incentives; coded 1 if the sum of performance bonus and stock options exceeds 10% of total pay.

Table 3 shows that most European countries have significantly raised their degree of conformity to corporate governance practices, in the second half of the 1990s in Italy, Germany and Spain, earlier in the Netherlands and through the whole decade in France, which is actually scoring 'best' on this issue, missing only the conformity to the 'one share one vote rule' and still allowing for takeover defences.

*Table 3: Country Scores on the Conformity to the Principle Corporate Governance*

	1989	1994	1999
Belgium	2	2	2
France	3	4	5
Germany	1	1	3
Italy	0	0	3
Netherlands	1	3	3
Spain	0	1	3

*Source: Shinn (2001).*

This deeper transformation of France with respect to the principles of market-based finance is confirmed by Goyer (2002), who compares the process of refocusing on core competencies by large French and German firms. Such refocusing is a standard requirement of Anglo-Saxon institutional investors, who criticise the conglomerate form of corporations on several grounds: the cross-subsidization from profitable division to unprofitable units is a denial of market incentive mechanisms and makes outsiders' investment more difficult to assess;

a company with a diversified portfolio of activities should focus on a limited number of core competencies for fear of becoming a 'Jack of all trades'; (financial) markets are held to be far better at risk diversification than internal company procedures. Goyer (2002) shows that French and German companies have changed their corporate strategies of diversification in differentiated ways. French companies have reduced their degree of diversification to a greater extent than their German counterparts. Restructuring was more radical in France than in Germany. Therefore, France, more than Germany, has made significant steps towards market-based principles of corporate governance.

The turn towards more market-based finance principles also concerns the market for corporate control, which can only be active if ownership is diffuse enough. Continental firms exhibit a higher degree of cross shareholding than their Anglo-Saxon counterparts. This pattern was initially preserved in France even after the second privatization wave in the mid-1990s. The so-called 'hard cores', i.e. a specific pattern of cross ownership linking large industrial firms, banks and insurance companies, aimed at preserving ownership stability and the capacity to implement long term industrial strategies. Of course, the presence of hard cores was particularly unattractive to foreign institutional investors, and was thus an impediment to the development of market-based finance in France. The hard-core structure soon entered a process of dismantling after the merger between insurance companies AXA and UAP in 1996.<sup>10</sup> The disappearance of the 'hard cores' subsequently encouraged foreign investors to enter the French share market. In Germany, the Tax Reform Law of July 2000 (*Steuerreform*) abolished capital gains taxes on the liquidation of cross-shareholdings. This was a deliberate policy to dissolve the cross-shareholding pattern characteristic of the long term relationships between corporations and banks. Neither party seemed that interested in keeping the close relationship going; as mentioned above, firms were eager to obtain cheap capital from financial markets and universal banks wanted to reorient towards the investment banking business. The tax measure was also thought as an instrument to boost the German securities markets and force German companies to restructure and adapt to a changing economic environment. The consequences on the ability of German corporations to resist hostile takeovers without a solid pattern of cross-shareholding were however under-estimated, as will be seen below.

The dynamism of the market for corporate control is probably best appreciated through the hostile takeover activity. Table 4 shows that it has noticeably gathered pace in Continental European countries during the 1990s. Hostile takeovers used to be very rare in Germany before that decade, but they

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<sup>10</sup> Morin (1998).

are no longer impossible as shown by the impressive increase in both target and acquirer takeovers. An important event in this respect was Krupp's attempt at a hostile takeover of its competitor Thyssen in 1997. As a symbol of the demise of the close relationship bank-based system in Germany, the hostile takeover attempt was prepared by subsidiaries of the *Hausbank* of both Krupp and Thyssen.<sup>11</sup> For the first time, German Banks not only let a hostile takeover take place but actually sided with the attacker. As with the case of company restructuring, France seems more involved in the practices characteristic of market-based finance than Germany, and the end of the decade was marked by large scale hostile takeovers in banking (BNP, Paribas and Société Générale) and oil industry (Elf and Total-Fina).

*Table 4: Announced Hostile Corporate Takeovers*

Country	Transaction Value (% of World Total)			
	Target		Acquirer	
	1980-1989	1990-1998	1980-1989	1990-1998
France	1.9	5.4	2.9	3.6
Belgium	0	0	0	0.1
Austria	0	0.1	0	0.1
Germany	0.2	1.8	0.2	1.8
Portugal	0	0.2	0	0.2
Spain	0	0.1	0	0.1
Switzerland	0	0.1	2.1	0.7
United Kingdom	18.4	18.2	18.6	17.5
Norway	0	0.6	0	0.4
Netherlands	0.1	0	1.6	0.1
Denmark	0	0	0	0
Sweden	0.1	0.6	0.2	0.7
Finland	0	0.1	0	0
Italy	0	0.7	0.3	2.5
Ireland	0	0.1	0	0.1

*Source: Guillen (2000).*

If one goes back to Roe's point about the links between politics and systems of corporate governance, it may come as a surprise that the most fundamental changes having taken place in the financial systems of France and Germany

<sup>11</sup> Lütz (2000).

were initiated under social-democratic governments. The most important privatization programs and financial liberalization measures were implemented by the socialist party in France, and the German Control and Transparency Law (*KontraG*) of 1998, which was part of a financial markets-promotion strategy aiming at reinforcing the protection of small owners and more generally adapt Germany to Anglo-Saxon corporate governance, was passed under a red-green government. This law prohibited banks holding more than 5% of a corporation's shares to vote with their equity *and* the proxies deposited with them, and was thus an incentive to reduce their stakes in German firms. In the desire to protect minority shareholders, the law prohibited unequal voting rights; it abolished voting ceilings and forbade the voting of cross-shareholding stakes over 25% in the supervisory board. In conjunction with the tax reform which created incentives to unwind cross-shareholdings, i.e. to radically alter the system of corporate governance in Germany, and, if one believes in institutional complementarity, to lead to a major change of the German model of capitalism.

The influence of the 'third way' ideology over left-wing parties in Continental Europe (Amable, 2003), the desire to liberalize financial systems in order to provide cheap financing for the State, and the lack of perception of the coherency of the models of capitalism are all influences that partly explain the evolution of the systems of corporate governance in Europe. A precise assessment of the relative influence of these and possibly other factors on the course of events is left for further research.

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