

Corporate Governance and Sustainable Prosperity. Edited by William Lazonick and Mary O'Sullivan. Basingstoke, U.K.: Palgrave, 2002. Index, figures, references. Cloth, \$72.00. ISBN 03-33777-573.

Reviewed by David Merrett

The theme of this well researched and powerfully argued volume is that corporate governance matters and that the new fashion of maximizing shareholder value may be a road to ruin. This book is of great interest to business historians because its arguments resonate with Chandlerian issues about differences in national business systems and long-run economic performance. In the first half of the last century, the United States model of competitive managerial capitalism triumphed over the British and German models, in that U.S. firms came to dominate world markets in a range of industries. The story told by William Lazonick and Mary O'Sullivan is set half a century later, when the United States is losing, not winning. High-tech manufacturing firms are ceding market share at home and abroad to new competitors, most notably from Japan. U.S. managers have sought to maintain earnings, and the value of their stock options, by downsizing and outsourcing.

The nine chapters, five of which are written by the editors singly or jointly, cover four interconnected issues. The first is the paradox of sustained economic growth in the United States in the last half of the 1990s and a widening inequality in the distribution of earnings, worsening job security, and lowered benefits. Lazonick and O'Sullivan raise the broad issues in their admirable introduction. Philip Moss's carefully crafted chapter thoroughly reviews the data and offers a powerful critique of the explanations put forward by economists. He argues that the changing patterns of earnings distribution, job tenure, and entitlements cannot be solely explained with reference to "market responses to exogenous supply and demand forces," as they also reflect decisions made by managers in the light of the "changes . . . in strategy, behavior and organization inside of firms" (p. 212, emphasis in original). His contention is supported by three excellent case studies of U.S. high-tech industries that are struggling in the face of foreign competition. Robert Forrant's chapter on the machine-tool industry, Beth Almelda's on the jet-engine industry, and Chris Tilly and Michael Handel's on medical diagnostic-imaging equipment all show that the overwhelming response of managers to declining competitiveness has been to cut costs by outsourcing, automating and, above all, stripping skilled workers from the shop floor.

Why do managers from widely different industries follow the same path? Lazonick and O'Sullivan provide a spirited explanation in their chapter entitled "Maximizing Shareholder

Value: A New Ideology for Corporate Governance.” In brief, the issue is who controls the allocation of corporate resources: insiders or the market? The authors’ preference is unequivocal: insiders can make better decisions than the market, which takes too short-term a perspective. The virtue of relegating authority to insiders is that they can retain and retrain resources in ways that may lead to sustained innovation and competitive advantage, rather than divesting labor and capital back into the market for reallocation. Lazonick expands on this idea in his chapter, “Organizational Learning and International Competitiveness: The Skill-Base Hypothesis.” To build up and take advantage of their firm’s knowledge base, Lazonick argues, managers need to design structures that integrate both functional and hierarchical areas. This enables learning that is a collective and cumulative process, stretching over long periods of time. Skilled workers on the shop floor are a critical ingredient in these processes. Laying them off may help earnings by cutting costs, but it undermines the longer-term capacity of the firm to innovate.

Managers of U.S. manufacturing firms adopted strategies that successfully retained and retrained workers up to the 1970s. In separate chapters, Lazonick and O’Sullivan argue that Japanese and German corporations, respectively, have continued to follow this course up to the present, although pressures are intensifying in both countries to adopt the model that would maximize shareholder value. Managers were able to retain a degree of independence from the stockholders because of their reliance on retained earnings in the United States, or, in Japan and Germany, on committed funding from the banking system, which took a longer-term view of performance. Insiders lost control as a confluence of forces gave rise to the emergence of a new model of corporate governance in the 1980s and 1990s. These included the rise of free-market ideology, deregulation of financial markets, an explosion of debt financing that leveraged earnings, mergers, and acquisitions, leveraged buyouts and management buyouts, shifts in household savings from fixed interest to market-based securities, the rise of institutional investors, and issues relating to the provision of retirement incomes for aging populations with rising life expectancies. Owners or outsiders increasingly set the rules for the allocation of corporate resources. Managers, as O’Sullivan drolly observes, “with appropriate incentives for self-enrichment [became] ardent proponents of shareholder value” (p. 294).

Is this form of shareholder-value-driven corporate governance compatible with sustainable prosperity? Lazonick and O’Sullivan make a strong case that it might not be. The threats come from two directions. First, the loss of well-paid jobs to boost corporate earnings can have a negative effect on consumption demand. The widening inequalities of income and wealth associated with the substitution of capital and low-skilled workers for skilled workers could lead to a decrease in consumption and weaken social cohesion. The possibility of shareholder value

becoming the overriding goal of management in Japan and Germany poses serious challenges to their existing social and political structures. Second, firms that choose to downsize and distribute their surplus assets through the market may seriously impair their ability to innovate in the longer term. The case studies provide a strong argument that U.S. firms in machine tools, jet engines, and medical-imaging equipment would not easily win back the advantages they had lost to firms from countries where managers practice retain-and-retrain strategies to a greater degree. The new alliance between managers and shareholders that is transforming business behavior in many advanced economies may have been struck a body blow by the current scandals of falsified corporate earnings and flawed audit standards.

*David Merrett is associate professor in the department of management at the University of Melbourne. He has published extensively in the areas of banking and business history, including an edited volume, *Business Institutions and Behaviour in Australia* (2000). At present, he is working with two colleagues on a history of big business in Australia in the twentieth century and he is also writing a short biography of one of the richest men in Australia in the 1960s.*