Globalization and Corporate Governance

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Given the expansion of trade, migration, and capital flows, along with increasingly complex global organization of production, it is not surprising that last 30 years has seen a boom in research on globalization. Furthermore, given the rapid rise in the skill premium, throughout the OECD, over this period, it is probably not surprising that the great majority of this work has focused on the link between globalization and labor markets. What is perhaps surprising is how modest are the quantitatively estimated effects.[1] In the face of widespread public concern about various aspects of globalization, these results pose something of a problem. On the one hand, the results may simply be correct and the non-economist public incorrect. On the other, there are a variety of indirect channels via which globalization might be affecting the economy in general, and labor markets in particular, and which are not picked up by the standard methods used to identify those effects.[2] This has led to work that has examined such indirect channels as the effect of globalization on unions (1993, Borjas and Ramey 1995, Guadalupe 2007, Baccaro 2008) or the effect of globalization on the welfare state (Hicks 1999, Swank 2002, Pontusson 2005). In both cases there is evidence that globalization weakens these institutions, and further evidence that these institutions are associated with more equal distribution of income.[3] Thus these indirect effects seem a promising avenue for research.

While labor market institutions and political institutions have been widely studied in this context, corporate governance institutions have been much less widely studied.[4] This is somewhat surprising since, not only are firms the most significant institution in the capitalist economy, but there is considerable evidence of both cross sectoral and cross national heterogeneity in corporate governance institutions (Allen and Gale 1999, Keasey, et al. 2005, Morck 2005). This

[1] On the link between trade and wages see Slaughter (2000), for immigration and wages see Card (2009).
[2] It is easy enough to see how this can happen. For example, consider the effect of trade on wages as mediated by unions. Trade might well weaken unions, but need not do so in any way identified by mandated wage regressions. That is, the sectoral pattern of weakening need not be correlated with changes in relative prices.
[3] For the effect of unions on income distribution, see Freeman (1993), Card, Lemieux, and Riddle (2004), DiNardo, Fortin and Lemieux (1996) or Fortin and Lemieux (1997). On the link between welfare state effort and income distribution, see Huber and Stephens (2001) or Pontusson (2005).
[4] It should be noted that, while this statement is true of economists and political scientists, researchers in law and finance have devoted some considerable effort to corporate governance and the political economic links to globalization.

suggests that more systematic study of the way corporate governance structures condition adjustment to globalization and the way corporate governance institutions respond to globalization are potentially questions of considerable interest. In the remainder of this introduction I will briefly review definitions of corporate governance and sketch the relevant parts of the basic literature. From there the next section considers the literature on corporate governance and globalization in the context of non-catastrophic shocks, while the remaining section considers how the presence of a major economic shock might alter the conclusions of the preceding section.

It is useful to be explicit about how I will use the term "corporate governance", since it is used in a wide variety of ways. Probably the most common definition in the literature is the one given in the excellent survey of the finance literature by Shleifer and Vishny (1997, pg. 737): "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". This definition reflects the concern, central to corporate finance and research on corporate governance more generally, that the separation of ownership and control, noted early on by Berle and Means (1937), should be a primary focus in research on the modern firm. While this definition has the virtue of clarity of focus, a number of scholars have noted that it may be excessively narrow. Rajan and Zingales (2000, see also Zingales 2000) note that, increasingly, the Berle-Means firm competes with, or is even displaced by, alternative corporate structures—especially in economically key service sectors. Allen and Gale (1999) argue that the standard definition reflects too much the concerns of American scholars. They argue that in many countries, this is an inaccurate representation of what is central to corporate governance. For example, a system like Germany's with co-determination explicitly empowers organized labor; while managers in Japan assert a broader notion of "stakeholders". These considerations lead Tirole (2001, pg. 4) to propose a more expansive definition as: "the design of institutions that induce or force management to internalize the welfare of stakeholders." This leads directly to a contract theoretic approach with a potentially broader range of agents. Zingales (1998) proposes a closely related definition that more explicitly emphasizes conflicts: "[A] governance system [is] the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated in the course of a relationship." Like Tirole's definition, Zingales contemplates a more expansive notion of corporate governance than Shleifer and Vishny's, but, in its emphasis on quasi-rents, it seems potentially less expansive than that of

Tirole. In this paper, I would like to emphasize the fundamentally political relationship by referring to corporate governance as the set of institutions that define and regulate the relations between insiders and outsiders in the context of the firm.[5] Among the obvious related parties are equity owners (various sorts), debt holders (various sorts), managers, workers (senior/junior, union/non-union), suppliers, and consumers.[6] Comparative analysis makes quite clear that the identities of insiders and outsiders vary considerably across countries. It would be surprising if such differences did not have implications for the analysis of adjustment to globalization. Before turning to this specific question, I briefly survey the general literature on corporate governance and economic (and political) performance.

In a world of constant returns to scale, perfect competition, and complete and perfect markets, there is obviously no role for corporate governance, even under the most expansive definitions above.[7] In a world with most standard distortions, while there may be a role for government intervention, *corporate* governance issues still do not usually arise. Exceptions arise in at least three sorts of case: informational distortions; missing markets; and politically/legally induced asymmetries. The most obvious exception relates to informational distortions. These distortions go to the heart of corporate governance issues. For Tirole and Zingales, as much as for Shleifer and Vishny, a defining characteristic of insiders is that they possess information that outsiders do not possess. In the corporate governance literature, the most common example is managerial opportunism in the face of dispersed ownership (Stein 2003). The idea is that it is in no individual owner's interest to acquire the relevant information. This leaves the manager free to channel resources in ways that are not value maximizing. In the absence of an active market for control, for example, there may be an incentive for individual owners to acquire large shares of a corporation (i.e. become blockholders). It turns out that Europe has much higher degree of blockholding than does the US (Becht and Röell 1999). This is often seen as a response to weaker protection of equity owners in the face of managerial opportunism—via legal or market

[5] For a similar emphasis see: Hellwig (2000); Pagano and Volpin (2001); and Rajan and Zingales (2003).
[6] At some remove, of course, we also have the local community, which is straightforwardly affected by the behavior of the firm; various levels of government that might make fiscal, and other, claims on the firm; auditors; analysts; regulators; etc.
[7] Allen and Gale (1999) note that in the perfectly competitive environment, decentralization has several important implications, including: value maximization as an unambiguous objective for the firm; decentralization of implementation if this objective to lower level managers; shareholder unanimity (i.e. all owners agree on this objective); and irrelevance of capital structure (generalized Modigliani-Miller theorem).

mechanisms (Shleifer and Vishny 1986).[8] Second, Allen and Gale (1999) stress the importance of incomplete markets to corporate governance. For example, with incomplete markets many of the standard results that are extensions of the Arrow-Debreu model no longer hold.[9] Third, the presence of unions creates insiders and outsiders in the sense of Lindbeck and Snower (1988), but corporate governance is implicated in this relationship as well. That is, it is clearly the case that corporate governance regimes across countries, and to a lesser extent across classes of firms within countries or sectors, differentially empower labor in governance decisions. For example, German law specifies that labor must be represented on the both the supervisory board and the management board, while US law contains no such requirements. Thus, union labor is rendered an insider in the German context and an outsider in the US context. The logic of this case could, in principle, apply to any "stakeholder" however distant (though politically well organized).[10] For example, laws might privilege debt holders relative to equity holders; making the former the insiders and the latter the outsiders.

The great majority of research on corporate governance has focused on micro and macroeconomic issues—i.e. the link between corporate governance regime and firm performance; and between corporate governance regime and aggregate economic performance.[11] In simple environments, both of these are straightforward: profit maximization is an unambiguous goal for all stakeholders; and profit maximization by all firms produces the best allocation of productive resources. In environments where corporate governance matters, these issues obviously diverge. In environments where insiders (e.g. managers, or managers and labor) face owners seeking value maximization, a better corporate governance environment will produce better macroeconomic performance. However, as we have already noted, this depends on a particular notion of who the insiders and outsiders are and the specific nature of the rule in place. In general, rules that ensure that, loosely speaking, outsiders are treated "fairly" by insiders need not ensure that resources are optimally allocated from a strictly economic

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[8] It should be noted, however, that it has proved hard to find evidence of economically significant impacts of blockholders (Holderness 2003).

[9] Relative to footnote 7, Allen and Gale (1999) sketch the argument that all four of the implications can fail with incomplete markets, and then develop a systematic analysis of these implications through the remainder of the book.

[10] Hellwig (2000) and Pagano and Volpin (2005) both develop political economic analysis in which it is precisely management and labor (the insiders) that exploit owners (the outsiders).

[11] This literature is immense—in fact the number of high quality surveys on these issues is large. I found particularly helpful the general surveys by Shleifer and Vishny (1997), Zingales (Zingales 1998, 2000), and Becht, Bolton and Röell (2003).

efficiency point of view. At the firm level, the theoretical work identifies a number of plausible channels through which specific elements of corporate governance can affect firm efficiency (usually associated with value maximization). The empirical work, seeking to identify effects of particular governance mechanisms at the firm level (e.g. takeovers, blockholders, boards, compensation contracts, etc,) struggles to find definitive results.[12]

The problem is somewhat different with research at the level of the economy as a whole: comparative results seem to be driven (at least in part) by current policy trends. Thus, in the 1980s, much of the research on corporate governance seemed to support arguments that German and Japanese corporate governance regimes supported stronger firm performance; while in the more recent period exactly the opposite conclusion was widely supported (Becht, et al. 2003, section 6). This seems to be consistent with analyses that see corporate governance regimes as part of broader political economic structures that developed historically in response to specific challenges. As a result, some regimes deal with certain shocks better than others (e.g. supply shocks and inflation v. unemployment). The notion that laws and institutions are characterized by complementarity that supports generates institutionally based comparative advantages is common to the literature on varieties of capitalism (e.g. Hall and Soskice 2001), discussions of path dependence in the legal literature on corporate governance (e.g. Bebchuk and Roe 1999), and recent work in corporate finance suggesting intersectoral effects of corporate governance regimes generating sectoral comparative advantage (e.g. Allen and Gale 1999, Carlin and Mayer 2003). A pathological version of this relates particularly to countries in transition and some developing countries, where lack of protection for investors is so extreme that potentially productive investments are not made—interfering with firm performance, aggregate economic performance, and sectoral comparative advantage.[13]

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[12] Easterbrook (1997) maintains the position that differences in corporate governance are essentially irrelevant in cross country comparison. The basic idea is that firms can contract around virtually any legal structure. For him, the essential difference between countries is economic, not legal, structure. Interestingly, the position that economics is more important than specific legal structures is more common among legal scholars than among economists (Black, Bernard S. 2001, Cheffins 2001, Coffee 2001).

[13] Shleifer and Vishny (1997, pg. 739) point out that "[countries such as the US, Germany and Japan] all have the essential elements of a good governance system, the available evidence does not tell us which one of *their* systems is the best. In contrast, corporate governance in most other systems…lack some essential elements of a good system". A substantial body of literature links such lacks to poor aggregate performance (Morck, et al. 2005). Similarly, recent work by Anderson and Marcouiller (2002, also see Anderson and Young 2006, and Li and Samsell 2009) have argued that poor protection of legal rights affects trade performance.

In addition to the economic effects of corporate governance regimes, that is the focus of the great majority of research on this topic (and that will underlie most of the discussion in this paper), it should be noted that these institutions play an essential role in supporting the legitimacy of the market and even of democracy when faced with a major crisis (e.g. a widespread scandal and/or a major economic downturn). We will return to these issues in the last section of this paper.

I. Globalization and Corporate Governance: Non-Catastrophic Effects

A. How Does Globalization Affect Corporate Governance?

Research on corporate governance focuses on one major question in terms of adjustment in corporate governance practices and regimes to globalization: does globalization induce convergence? In more inflammatory terms, the question is whether globalization induces firms and governments to "race to the bottom"—i.e. to adopt minimally restrictive rules.[14] The notion that globalization causes (or, at least, might cause) convergence is common across a broad range of policy areas—monetary and fiscal policy, exchange rate policy, trade policy, welfare state policy, etc.—so it is not surprising that this has been argued for the case of corporate governance. The arguments for why there might be convergence are straightforward, as are the arguments for why there might not. As with the research on the effect of globalization on other policy areas, the empirical work is considerably less clear. We begin with the theory.

I will divide accounts of convergence into those deriving from policy learning, competition, and imposition/negotiation. In the case of learning and competition, it will be important to distinguish between effects of globalization on firm level governance choices and on government policy choices.[15] Morrissey and Nelson's (2003, 2005) analysis of policy learning identifies three basic modes of policy learning: decision theoretic learning; social learning; and hierarchical social learning. The analytically simplest account of policy convergence doesn't require globalization at all; governments or firms experiment with governance mechanisms on their own, incrementally adopting changes that improve performance. Over time, if there is a single best

[14] Of course, for many analysts, a movement toward laissez faire would be seen as a race to the *top*.
[15] The presumption in most of the literature is that causality runs from government policy to firm governance choices, but it is entirely possible that the causality runs the other way (firms adopt conventions, which are then adopted by governments).

form of corporate governance, and there are no locally stable regimes or practices, all governments or firms will converge on the same regimes/practices. Arguments that there is a single best regime/set of practices implicitly or explicitly assume that it can be approached through this kind of experimentation. In Hansmann and Kraakman's (2001) widely cited "End of History" essay, the argument from "The Force of Logic" (pg. 449) for the superiority of the "shareholder oriented (or standard) model" (pp. 440-441) is of precisely this sort. The basis of this claim is a version of the standard argument for why equity investors ("capital") should control the firm: they are uniquely unable to protect themselves with complete contracts; and, if they are granted control rights, they will pursue an objective of value maximization which is optimal for all other "stakeholders". We have already seen that this claim relies on very strong assumptions about the underlying economy such that, if the environment is one that makes corporate governance an issue of interest, this claim almost surely fails (Allen and Gale 1999, chapter 5). Furthermore, in most environments of any complexity, the model of decision theoretic learning does not generically converge on the best outcome (e.g. Aghion, et al. 1991, Banks, J. S. and Sundaram 1992, 1994). Thus, decision theoretic learning does not guarantee convergence.

The discussion of the preceding paragraph presumes that policymakers/firms learn exclusively by doing. That is, a policy is adopted, an outcome occurs, and the policy is evaluated relative to the agent's beliefs about existing alternatives. It is surely the case that significant learning also occurs through observation of the policy experience of others. This still presumes that there is a single universally best form of corporate governance for the firm or government. Hansmann and Kraakman (2001) treat this case as "the force of example" (pg. 450). There is certainly evidence that governments actively observe the policies of other governments and use that information in constructing new policies (Banks, James W., et al. 2005). It seems equally plausible that firms observe the behavior of other firms. Thus, suppose that there are a finite number of firms/governments that can observe the choices made by other agents, but not their private information. Each now updates based on their private information and what is implied by the observable choices of others. In relatively simple environments of this sort, agents converge in finite time; however, they need not converge on the optimal policy. As with decision theoretic learning, it is possible that, after observing the actions of some number of governments (or firms), successive agents will ignore their own information and follow the actions of the others.

The literature refers to this as "herding" and the loss of information induced thereby as an "information cascade" (Bikhchandani, et al. 1992). That is, because policymaker's herd, potentially useful collective information is lost. It is important to note that the possibility of cascading or herding on an inefficient policy does not imply that social learning is in any sense worse than private learning. The social learning case embodies two distinctive elements relative to the private learning case. First, every policymaker observes more information at each *t*, at least until a herd occurs. However, and this is the second point, where the private learner internalises the trade-off between expected current reward and accumulation of information, in the social learning context only private learning is internalised in this fashion. That is, there is an information externality.[16] Thus, the basic version of this model does predict convergence; though, again, not necessarily on the objectively best policy. In addition, in more complex environments, type specific herds can arise—i.e. no general convergence at all and none need converge on the best policy (Smith and Sørensen 2000).[17]

Ultimately, then, claims that learning must lead to convergence and, in particular, must lead to convergence on the objectively correct policy tell us more about the proponents of such claims than anything that is warranted by the theory. Even assuming that there is an objectively best corporate governance regime (e.g. Hansmann and Kraakman's "standard model"), research on learning does not lead us to generally expect convergence; and when there is convergence, it does not require convergence on the objectively best policy. Arguments that stress the role of competition in driving convergence thus seem, potentially, more compelling (e.g. Hansmann and Kraakman 2001, pp. 450-451). Such arguments do not require the assertion of an objectively best policy/practice from the perspective of all stakeholders. Rather, like evolutionary arguments, they require local optima induced by the competitive environment, but imply no claim that necessarily informs policy.[18] Before considering competition of governments, let us consider the effect of globalization of the competition among firms, and the way that might affect firm-level corporate governance choices.

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[16] Smith and Sørensen (2000), in their welfare analysis of informational herding in a cascade model, develop the notion of a team equilibrium in which agents collectively incorporate this externality. This paper also draws attention to the close relationship between social learning models and private learning models.

[17] Chamley (2004) is an excellent presentation of all this material on social learning, herding, cascades, etc.

[18] That is, policy might generally be seen as affecting the structure within which this competitive process takes place.

From the point of view of the firm, globalization implies greater competition, but it also implies participation in more markets for inputs (including capital, intermediate goods and factors of production) and outputs. To the extent that any of these markets become more integrated, there must be a strong presumption that there will be strong pressure to adopt strategies and structures that make the firm as competitive as possible. Globalization of markets for intermediate products has had a major impact on the organization of firms. The opportunities for firms to engage in globally structured production through outsourcing, as well as multinationalization, induces firms to adopt new governance structures to manage the new production structures. Responding to increased opportunities and threats resulting from globalization in the market for final goods could also cause firms to consider reorganization of its corporate governance practices. In addition to straightforward learning by doing and by observation, the move to new production structures and new competitive conditions often involves hiring consulting firms. To the extent that consulting firms are prone to herd (we return to this in the discussion of hierarchical learning below), this might accelerate the convergence effects of product and factor market competition.

It is worth isolating the emergence of an increasingly global capital market as an independent force in promoting convergence in corporate governance. As firms face an increasingly competitive environment in the markets for real factors, intermediates and final goods, financing can (at least in principle) be a major factor in competitiveness. In addition to the widely remarked increase in financial flows, there has been a sizable increase in the listings of firms on foreign (especially US and UK) equity markets. Especially for firms from countries with very tightly regulated, or very inefficient, capital markets, access to international markets can be a major competitive advantage. One possibility is that firms are benefitting from lower costs of listing on more efficient stock markets, thus lowering their cost of capital. The international finance literature refers to this as the *segmentation view* (Black, Fisher 1974, Errunza and Losq 1985, Alexander, et al. 1987). An alternative model, the *bonding view* (Coffee 2002, Goergen and Renneboog 2008), argues that firms from countries with weak corporate governance regimes can signal their quality by listing in markets with higher investor protections.[19] Again, the effect is to lower their cost of capital. In either case, to list on either the US or UK market, firms must

[19] Useful reviews of the literature on cross-listing can be found in Stulz (1999), Karolyi and Stulz (2003), and Karolyi (2006).

adopt standard reporting practices. Thus, in both cases firms voluntarily converge on Hansmann and Kraakman's (2001) standard model. The logic of convergence is also straightforward for countries. With respect to corporate governance, the lever is competition for firms listing on national stock markets and incorporating in the country (Hansmann and Kraakman 2001, Coffee 2002, Chemmanur and Fulghieri 2006, Doidge, et al. 2007).

All of the accounts of convergence to this point emerge from decentralized response to globalization. It is also possible that more hierarchical and political processes could play a role. We consider, briefly, hierarchical learning, bargaining, and imposition. In the case of social learning, we might imagine a positive role for research by analysts exogenous to the government or firm decision problem. In this case, private researchers are simply providing a service to governments or firms trying to identify the correct policy. However, what Morrisey and Nelson call hierarchical learning endows these researchers with priors and preferences that may differ from those of the governments or firms, and may possess the power to encourage governments to follow their conclusions. The most obvious case here would be the relationship between a government and the firms within its jurisdiction (though transnational or international agencies might well play this role with respect to governments. Note that we are not here focusing on the ability of the hierarchically superior agent to compel obedience, only with its central role in the collection and transmission of information.

With reference to the literature on information cascades, Gul and Lundholm (1995) make a useful distinction between *statistical cascades* and *reputational cascades*. To this point, I have been discussing what are essentially statistical cascades—potentially useful information is lost as a result of herding which results strictly from the rational behavior of individual agents. By contrast, a reputational cascade is driven by an agency relationship embedded in the sequential decision problem. The central reference here is Scharfstein and Stein (1990), who consider a model of investment by managers in an environment characterized by common prediction error in their decision to make one or another investment. This means that owners, in evaluating the performance of managers, consider both outcomes and whether a given manager did the same thing that other managers did. A contrarian success is good, but a contrarian failure is very bad for an analyst's career. This creates an incentive for herding, even if there is no convergence in beliefs. As we noted above, in passing, these same sorts of pressures exist in business

consulting. These pressures may be enhanced by common training, exposure to common literature on governance, etc.

Suppose that firms do not observe the governance choices of other firms, but that economists (or consultants) collect information on the choices of firms and make the information available in a public fashion. Without the economists, we would be in a purely individual decision theoretic world so there would be no herding and no cascades. That is, we would expect to see heterogeneity in the corporate governance practices of firms and we would expect that proportionally more of those firms would adopt objectively optimal policies. If economists were linked as in social learning, the results would be the same as that case—herding/cascades in finite time and the possibility of herding on a sub-optimal policy. However, Morrissey and Nelson argue that there are two potentially distinctive elements here. First, if economists advise governments and governments are able to insure firms that adopt preferred governance structures (or, more strongly, if governments adopt formal rules), this could induce cascades more quickly than in the observational learning case. Second, if, as a result of elective affinity, common training, reputation effects, or some other factors, economists are more prone to herding than policymakers, the existence of an agency that enforces the beliefs of economists will have two effects. To the extent that, because they are aggregating information from a number of countries, their conclusions are more accurate, this should raise welfare by encouraging the adoption of better policies. Because this institutional arrangement encourages rapid herding, information will be lost, increasing the likelihood of a herd on an inferior policy. Which of these effects dominates is far from clear, though it does seem worth noting that economists (and business consultants) do appear quite prone to herding.

Hierarchical social learning raises, pretty directly, the issue of direct imposition. It is a (fairly well considered) presumption of virtually all policy recommendations on corporate governance that governments can impose a corporate governance regime within its territory, but a binding corporate governance regime necessarily implies firm-level "convergence" within that territory. If we suppose that negotiation of a preferential trade agreement with a more powerful country could involve the imposition of preferences over elements of corporate governance, or negotiation of a high conditionality loan from the IMF or world bank involves conditions on corporate governance, and those institutions have a preference for a particular sort of regime

(presumably the “standard model”), such imposition could easily produce convergence. Of course, one need not presume that there is asymmetry, two (or more) governments could agree to harmonize their corporate governance regimes, leading to convergence. The process of European unification has generated pressures for more systematic, community-wide, regulation of corporate governance. For example, over the last several years there have been attempts in many European countries to reform takeover regulation, usually in the direction of the standard model. (Goergen, et al. 2005). In the closely related area of industrial regulation, there has been extensive talk about using the WTO or the OECD as a vehicle for convergence (Evenett, et al. 2000). These hierarchical relations need not involve governmental entities. In recent years, stock exchanges, professional associations, investors associations, and the like, have been actively involved in promoting codes of best practice (Aguilera and Cuervo-Cazurra 2004, 2009). Even voluntary codes will tend to induce convergence across firms and, to the extent that similar codes are adopted across countries (or firms list on foreign exchanges possessing such codes), there may also be convergence across countries.

B. How Does Corporate Governance Resist Globalization?

At least in some quarters, it is believed that globalization is an irresistible force driving all countries toward common economic, political, and even cultural forms and practices. At the same time, the evidence for such convergence is, at best, mixed. What sorts of factors might be standing in the way of such convergence. The usual candidates are multiple equilibria, political resistance by interested parties, and cross-national differences in values and norms. We consider each in turn.

A presumption of most of the arguments for convergence considered in the previous section is that there is a single, uniquely best set of corporate governance practices for firms and a single, uniquely best corporate governance regime for governments. This may be because such a regime exists unconditionally as the best (Hansmann and Kraakman 2001) or that competition under globally applicable conditions produces a local optimum to which everyone must conform (or die). The presence of multiple, stable equilibria obviously interfere with the logic underlying all of the arguments in the preceding section. There are many variants of arguments for multiple equilibria, but I will focus on three that seem to contain most of the essential notions: increasing

returns; complementarity; path dependence. None of these are precisely distinct from the others, but it is useful to consider the effect of each with respect to the effect of globalization on corporate governance.

Probably the easiest way to generate multiple equilibria is with increasing returns. As W. Brian Arthur notes (Arthur 1994, pg. 112): "…usually self-reinforcing mechanisms are variants of or derive from four generic sources: large set-up or fixed costs (which give the advantage of falling unit costs to increased output); learning effects (which act to improve products or lower their cost as their prevalence increases); coordination effects (which confer advantages to 'going along' with other economic agents taking similar action); and self-reinforcing expectations (where increased prevalence on the market enhances beliefs of further prevalence)." For both countries and firms, the adoption of a corporate governance regime implies substantial fixed costs, but the most significant effects probably come from coordination effects and self-reinforcing expectations. That is, in addition to regulating the opportunism of insiders (to some extent), corporate governance regimes provide a focus of expectations against which to evaluate performance, promise keeping, *et cetera*. These stable expectations play an essential role in stabilizing the business environment. Any substantial change would necessarily involve substantial transition costs. These costs must be weighed against any benefits to be had from shifting regimes. We have already noted, with reference to Shleifer and Vishny (1997, pg. 739), that most relatively wealthy OECD countries already have "the essential elements of a good governance system", suggesting that the gains from change will generally be small.[20] In addition to multiple equilibria, Arthur (1989) notes that increasing returns also generate: possible inefficiency; inflexibility ("lock in"); and non-ergodicity ("path dependence"). We will turn to the latter two dynamic effects shortly, but it is easy enough to see that, if the costs of switching regimes are sufficiently large relative to the gains, it is entirely possible to be stably in an inefficient equilibrium.[21]

Where increasing returns is a clear concept, "complementarity" gets used in a bewildering variety of ways. Milgrom and Roberts (Milgrom and Roberts 1995, pg. 181) offer a general

[20] The cases of developing countries and countries in transition are, of course, quite different.

[21] It should also be noted that, in the context of interdependent policies, a given regime may result in on party (firm or country) being locked in a "bad equilibrium" as part of the overall equilibrium that puts the other party in a good equilibrium.

definition of complementarity that provides a good place to start: "activities are *Edgeworth complements* if doing (more of) any one of them increases the returns to doing (more of) the others." The notion of complementarity has found wide application in economics.[22] Although the analysis is less formal, the same concept is central to the varieties of capitalism (VoC) literature in political science (Hall and Soskice 2001, Höpner 2005, Hall and Soskice 2006). The idea here is that certain political and economic structures "hang together". In particular, the authors in this tradition distinguish between "liberal market economies" (e.g. the US and the UK) and "coordinated market economies" (e.g. Germany and Sweden). The usual emphasis in this literature is on consistency of welfare state, regulatory, and macroeconomic regimes. However, it is also recognized that corporate governance regimes are distinctive between these systems, and that they play a central part in the constitution of these regimes (e.g. Vitols 2001b, Amable, et al. 2005, Höpner 2005, Ahlering and Deakin 2007, Jackson and Deeg 2008). Similar relations of complementarity exist within the systems of corporate governance (Aoki 1994, Aguilera, et al. 2008). One of the essential claims in this literature is that changing a single element (even a large one such as corporate governance) would generally hurt the overall efficiency of the aggregate regime. It should be clear that complementarities within the corporate governance system and between the corporate governance system and the overall political economy would be a substantial barrier to convergence.[23]

Where the increasing returns and complementarity are essentially static notion, path dependence ("non-ergodicity") is an essentially dynamic concept. Paul David gives a good general definition of path dependence: "A dynamical process whose evolution is governed by its own history is path dependent" (David 2007, pg. 92).[24] Loosely, the idea is that "history matters". The specific events that make up a history, and the order in which they appear, matter for the state of a history at any point in time. The fact that models with increasing returns, or externalities, and thus

[22] Among these: Milgrom and Roberts (Milgrom and Roberts 1990, Milgrom, et al. 1991, Milgrom and Roberts 1994) have used complementarity to examine the economics of firms and sectors; Matsuyama (1995, 1997) trade and growth; and Krugman economic geography (Krugman 1991).

[23] Complementarity has implications for research as well. In particular, if components of corporate governance regimes are linked by strong complementarity, their components cannot be treated as individual variates.

[24] David's paper is also a very nice introduction to the main concepts in the analysis of path dependence in the social sciences. Arthur (1989) makes a useful distinction between inflexibility ("lock in") and non-ergodicity (path dependence). Both are dynamic concepts, but where the first reflects a general resistance to change and a tendency to retain a given regime in the face of pressure for change; the latter reflects a general tendency of the current state of a system to reflect its past history. An ergodic system is to converge on a deterministic point—i.e. the outcome is independent of path.

multiple equilibria, generate path dependent histories has been exploited in a number of areas of economics (e.g. Nelson and Winter 1982, Krugman 1991, Durlauf 1993, Arthur 1994). Where increasing returns and complementarity create a presumption that there are forces resisting convergence, path dependence (like convergence) is specifically about dynamics. In an early, and widely cited analysis of path dependence in corporate governance, Bebchuk and Roe (1999) identify two sources of path dependence: structure driven path dependence; and rule driven path dependence. The former reflects the original ownership and governance structures adopted by firms and the specific ways that they have evolved; the latter reflects the interaction between these structures and the regulatory structures that grew up around them. These generate the dynamic persistence that is an obvious feature of the data.

A simple form of path dependence is resistance to change (this is Arthur's "inflexibility"). That is, once a corporate governance regime, or set of practices, is adopted, there are strong social forces that resist such change. One of the obvious sources of inflexibility is political entrenchment. Mark Roe has been one of the leading proponents of a political account of corporate governance (Roe 1994, 2003) and has used this as an explicit account of resistance to change (Bebchuk and Roe 1999).[25] For Roe, the main axis of political competition is between capital and labor. An alternative approach to the politics of corporate governance is to focus on sectoral political organization. Recent work in the VoC tradition emphasizes politics in which capital and labor organize by sector and the politics are driven by intersectoral effects of governance structures (Jackson 2001, Vitols 2001a, Jackson 2003, Vitols 2003). Among economists, the most common version of the political model pits insiders (usually managers and labor) against outsiders (usually owners) (Hellwig 2000, Fehn and Meier 2001, Rajan and Zingales 2003, Pagano and Volpin 2005, Perotti and von Thadden 2006). One implication of the usual VoC analysis is that different cleavage patterns might characterize countries in different categories. Specifically, liberal market economies seem more likely to be characterized by class conflict, while coordinated market economies might be better analyzed as insider-outsider conflicts. Whatever the cleavage pattern, the general claim that the winners of the conflict will resist change obviously implies non-convergence as long as they remain politically dominant.

[25] Gourevitch and Shinn (2005) is an interesting overview and extension of the various political accounts of corporate governance.

The political models discussed in the previous paragraph seek to explain the stability of corporate governance structures as a function of the stability of (some) political coalition. An alternative is to seek stability in underlying preferences of uncommitted citizens—that is, in broad social norms. I will return to this in the last section of this paper, but it is worth noting here that, if government adopts policies that are too far removed from general social norms, losers in the political conflict can seek to improve their outcome by mobilizing undecided citizens by appealing to widely held norms (Schattschneider 1960, Riker 1986). If this mechanism is effective, and different countries are characterized by different norms regulating economic activity, the norms would be a source of stability, reducing the responsiveness of an economy to pressures for convergence.

C. What Is the Empirical Relationship between Globalization and CG?

The previous two sections argued, respectively, for and against a presumption that globalization tends to produce convergence in corporate governance regimes and practices. It is now time to see what kind of evidence there is relating to these theoretical claims. Unfortunately, as with nearly all empirical research on the effects of globalization, definitive results (even negative ones) are hard to come by. Note that this is *not* to say that there is definitive evidence against convergence, but that there is little consistent evidence either way. Part of the problem is that, while the phrases "corporate government" and "convergence" seem to connote reasonably specific things, operationalization is generally problematic. We will consider a few issues of operationalization before briefly summarizing the main lines of result in the empirical literature on corporate governance.[26]

As much of the forgoing discussion suggests, "corporate governance" refers to a rather complex set of issues at both the firm and government levels. For firms, there are a very large number of components of corporate governance, even under Shleifer and Vishny's (1997) definition. At a minimum, there are issues related to the board (number of, size of, shares of inside and outside directors), identification of insiders and outsiders, role of banks, role of blockholders, nature of

[26] There are very large literatures attempting to identify the economic effects of corporate governance on firm performance. This research is obviously relevant, but we will focus only on the considerably more limited research that directly examines the issue of convergence. A useful overview of the more general empirical research on governance, including references to the many topic specific surveys that exist is Becht, Bolton and Röell (2003, section 7).

managerial contracts (in particular the role and structure of performance contingent pay). At the level of regime, in addition to the degree to which the firm-level issues are mandatory, we would want to know about the protection afforded to minority share holders, the role and ease of takeovers, the nature and enforcement of reporting standards, legal right to cross-list. There are extensive literatures on virtually all of these individual components, but very little in the way of attempts to identify complementarities among the components. Thus, we don't really know what exactly we are measuring when we consider any of these components individually.

It is clear enough that "convergence" in corporate governance means that some measures of corporate governance are becoming more similar. Unfortunately, since it is not quite clear what "corporate governance" means operationally, convergence is also tricky. The most common strategy is to identify some relatively well-defined element of corporate governance (e.g. takeover rules or presence of blockholders on boards) and ask whether, for some pair of countries, they have moved closer together. However, even in this case, there are further complexities. At the level of the firm, Gilson (2001) argues that we need to distinguish between formal and functional convergence. The easiest thing to measure is formal convergence, or lack thereof, on any of the detailed components of corporate governance. However, firms may well be able to functionally resist convergence even when formal structure converge; and, just as easily, firms might well provide equivalent governance even when formal structures differ.[27] In a sense, the theory requires functional convergence, and formal convergence is hopefully an unbiased indicator of functional convergence (Siegel 2005). Much of the literature that attempts to empirically distinguish between the two tends to find that they differ and, more often than not, that what convergence there is is formal convergence. At the level of the economy, the common distinction between *de jure* and *de facto* convergence seeks to capture the same sort of issue (Pistor, et al. 2000, Khanna, et al. 2006).

Early studies of country convergence relied on essentially qualitative methods (Nestor and Thompson 2000) or a mix of qualitative methods and tabular analysis of changes (Guillén 2000, Guillén 2001). While these studies identify some elements of convergence (Nestor and Thompson), the overall conclusion of both is that national systems of corporate governance had

[27] Part of Hansmann and Kraakman's (2001) analysis can be seen as saying that, in equilibrium, anything that looks like divergence is a "harmless mutation" (pg. 465). In this case, multiple equilibria are irrelevant—they are functionally equivalent and produce the same level of efficiency.

been quite robust to globalization. Furthermore, both conclude that this robustness is likely to be a feature of corporate governance regimes for the foreseeable future. Financial economists argue that hostile takeovers are one of the most effective instruments for controlling insider opportunism (Jensen 1986, 1988) and are a central part of the standard model toward which corporate governance regimes are expected to converge (Hansmann and Kraakman 2001, pp. 457-458). Schneper and Guillén (2004) and Goergen, Martynova and Renneboog (2005) both study convergence in takeover regimes. Schneper and Guillén find that distribution of takeover activity, which differs dramatically across countries, is consistent with differing patterns of relative political power. This result suggests, following the political model, that countries resist convergence. However, they also found that their meaures of foreign influence increase takeover activity. Thus, to the extent that globalization increases foreign participation in national economies, there is some pressure for convergence. Goergen, *et al*. collected expert judgements on detailed components of takeover regulation in Europe. They identify clear evidence of *de jure* convergence among members of the EU. The authors note, however, that such *de jure* convergence need not produce *de facto* convergence. In this regard, it is interesting to note that recent research using firm level data continues to find strong country (and region) effects in data on firm governance choices (Khanna, et al. 2006, Doidge, et al. 2007). In particular, Khanna, Kogan and Palepu (Khanna, et al. 2006) conclude that, while countries may be converging in formal governance standards, there is not much evidence of convergence in practice.

A number of studies at the firm level suggest that firms doing business in the US, or doing business with US firms, tend to adopt US-style corporate governance practices (Tuschke and Sanders 2003, Khanna, et al. 2004, Sanders and Tuschke 2007, Chizema 2008). At the same time, both Buck and Shahrim (Buck and Shahrim 2005) and Kahanna, *et al*. (Khanna, et al. 2006) conclude that this formal convergence is not matched by functional convergence.

In general, it seems reasonable to conclude that, whether we are talking about countries or firms, the pressures for convergence have not yet driven strong *de facto* (or functional) convergence. There is a sense, even in the face of functional convergence, that there is actual divergence. That is, although many countries have adopted policies that move them in the direction of an idealized US, the US and UK have also moved in that direction, and may have done so more decisively. Both the general weakness of support for the convergence hypothesis, and the conjecture about

increasing divergence between the US and the UK and the rest of the world, is broadly consistent with the extensive literature on convergence on monetary, fiscal and welfare policy. The strong presence of distinctive national styles remains a fundamental fact for corporate governance as for the political economy more generally. This is consistent with Stulz' (1999, pg. 1595) observation that "Despite the dramatic reduction in explicit barriers to international investment activity over the last 60 years, the impact of financial globalization has been surprisingly limited". At this point, it does seem reasonable to conclude that, *pace* Hansmann and Kraakman, whatever the future may hold, there is no evidence of an "end of history" for coporate governance.

It is worth noting that much of this conclusion reflects the fact that most relatively wealthy OECD countries have quite functional, though different, corporate governance systems. The story is rather different for countries, and especially for firms from countries, facing increased exposure to global competition from environments with poor corporate governance regimes. Previous research has shown that firms from countries with better investor protection have higher valuation (La Porta, et al. 2002, Shleifer and Wolfenzon 2002, Durnev and Kim 2005). and lower costs of capital (Klapper and Love 2004, Chen, et al. 2009). Similarly, unlike the lack of support for the case of industrialized countries, there is fairly consistent support in the data from developing countries and countries in transition for the argument that co-listing on the New York or London stock exchange serves a bonding function (Stulz 1999, Coffee 2002, Reese and Weisbach 2002, Doidge, et al. 2004, Abdallah and Goergen 2008, Hail and Leuz 2009).[28] For these countries, corporate governance is an essential part of the response to globalization. However, the goal must be to find a way to construct *some* good quality corporate governance regime. If the macro-complementarity/VoC perspective is correct, this task will be more successful to the extent that the regime, whatever it is, is solidly rooted in existing local values and political institutions, rather than that it conforms to whatever regime is currently considered to be abstractly best.

[28] Though it should be noted that there are contrary findings as well (Siegel 2005, Gozzi, et al. 2008). The paper by Gozzi *et al*. is particularly interesting in that it presents a careful test of the market segmentation against the bonding hypothesis, ultimately rejecting the latter in favor of the former.

II. Financial Crisis: Globalization and Structural Change

The previous section treated ongoing globalization as the primary source of pressure for change in corporate governance practices and regimes. In the current economic situation, we are also led to consider the effect of large shocks on corporate governance regimes. This is analytically, as well as practically, interesting since the global environment may be relatively stable over moderate periods, but shift substantially at particular moments, creating challenges that different corporate governance systems are differentially able to deal with. If it is the case, as the macro-complementarity-VoC analyses claim, that although all well-functioning corporate governance systems deal with stability more-or-less equally well, they may deal quite differentially with large shocks—and a system that deals well with, say, a sizable recession, may not deal well with a sizable inflation. We close this paper by briefly commenting on the differential capacity of political economies to respond to different types of shock, and the implications of the current economic situation for the future of corporate governance.

We have already seen that there is considerable evidence in favor of the notion that the elements of a nation's corporate governance system are broadly complementary, and that the corporate governance regime is similarly related to the broader political economy. We have also seen that, over periods of general stability, it is very difficult to identify one or another system as obviously superior. This is not because a decentralized, flexible shareholder-based system is functionally equivalent to a coordinated, bank-based system, but that, given the broader political economy in which each is embedded, they perform equally well (adjusting for the different objective functions that apply in the different systems). However, faced with broadly similar systemic troubles, these systems do not generally perform equally well. Thus, the corporatist systems of northern Europe handled the stagflation of the 1970s far better than the more flexible systems like the US. This led to discussions of the superiority of corporatist systems, with bank based corporate governance regimes that supported "diversified quality production" (Streeck 1991). Somewhat later, the same considerations led to a sizable literature on the superiority of the Japanese (Magaziner and Reich 1981, Johnson 1982, Porter 1990). Faced with a transition to a service based economy, the more flexible US economy was successful at generating jobs, while corporatist systems like Sweden experienced major crises. Focusing on any one of these periods might provoke one to imagine that there is a definitive best system, in the most current case that

there is an "end of history" (Fukuyama 1992, Hansmann and Kraakman 2001), but considering these different periods together makes us consider the more plausible conclusion that, given the different historical trajectories, these systems evolve better able to respond to some challenges than others. Systems that consistently fail to solve any current problems must ultimately change or fail. This should lead us to exercise a certain modesty when giving systemic policy advice.

The preceding paragraph leads us to expect considerable stickiness in institutional change. However, faced with a major shock, what can we say about directions of change in any given country? Writing in the aftermath of the Great Depression and just as the Second World War was ending, Karl Polanyi, reflecting on the interaction between democracy and capitalism, asserted the existence of a "double movement" between "economic liberalism" and the "principle of social protection" (1944, Part II: The Self Protection of Society). In explicit response to Marx, and the Marxists of his time, Polanyi did not see class struggle as the issue, but a struggle between man as a fundamentally social being and man as economic agent. Polanyi argued that capitalism ("the self-regulating market"), with its radical individualism, struck at the foundations of social order, creating widespread anomie. This opened the door to political entrepreneurs who offered to reintegrate society, usually in terms of some organicist notion of that society's identity—e.g. claims about the historic role of "The Nation" or "The Race". A turn to fascism in the major capitalist democracies seems exceptionally unlikely, both because governments seem to have a much clearer idea of how to respond to economic downturn now than they did in the 1930s; and because the institutions of capitalism and democracy remain widely accepted (again by contrast with the 1930s). Neither of these claims provides much comfort for the countries in transition and the developing countries.

A related account that might reasonably called Schumpeterian account, consistent with Schumpeter's analysis of business cycles and Weber's (Weber 1924/1978) concerns with the inconsistency between the rationality necessary to capitalism and democracy, recognizes that the median voter generally prefers a minimally risky environment, while the entrepreneurial forces that drive capitalism tend to generate higher risk. That is, Schumpeter argued that capitalism advanced via a process of creative destruction (1975, Chapters 7-9), a process that, while generating historically unprecedented growth over the long-run, also generated short- to medium-term instability and uncertainty. In a world where the median voter determines the

limits of policy, this is a recipe for socialization of risk and restriction on entrepreneurial effort. The relevance of this account is most easily seen in a reading of Rajan's (2006) prescient analysis of whether (deregulation of) finance has made the economy riskier. It seems quite likely that people are concluding, with Rajan, that finance *has* made the world riskier. And, thus, it seems quite likely that there will be pressure throughout the world to regulate finance. This drive reflects a Polanyian response to the increasingly widespread acceptance of the "standard model". At the same time, scandals of more-and-less significance to the crisis have raised other issues of corporate governance. These will also create pressure for "reform" of corporate governance to make it "less risky". These pressures for reform will be resisted by the beneficiaries of the existing system ("insiders") along the lines sketched above, but some response will be necessary to retain the legitimacy of both democracy and capitalism. The fact that the economy has become increasingly global, so that governments face increasingly common challenges, makes the study of the links between globalization and corporate governance increasingly interesting.

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