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**International Competition between Corporate
Governance**

Systems: Outcomes in the USA, Germany and Colombia

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Introduction

In the last two decades, globalization of capital, goods and service markets as well as the internationalization of production systems have intensified the international competition between corporate governance systems with respect to the attraction of production factors and the incorporation of firms. In theory, the possible outcomes of this competition lie between two poles. At one pole, efficiency considerations prevail and determine corporate evolution. Firms that adopt sub-optimal governance practices will disappear and countries that fail to adjust to changing market conditions will not be able to maximize social welfare. As a consequence, globalization will lead to the homogenization (i.e. convergence) of corporate governance provisions at both the company and country levels towards the optimum (Coffee 1999, p. 10, 11). At the other pole, path dependency (North 1996, p. 101), transaction costs (Witt 2003, p. 123), institutional complementarity (Gilson 2000, p. 7-9), multiple optima (Witt 2004, p. 5), and/or political forces (Bebchuck and Roe 1999, p. 17, 21, 38) counteract the trend towards convergence, causing persistence of diverse corporate governance systems.

Empirical work that evaluates the outcomes of the international competition between corporate governance systems (e.g. Gordon 2003, Jackson 2004, Schmidt 2003, Schneider and Chan 2001) is still in its infancy and faces serious limitations. Firstly, corporate governance systems are complex in so far as they consist of many provisions, rules, customs, and mechanisms whose effects can go in different directions, making the appraisal of the final outcome difficult. Secondly, data on some aspects of the systems (e.g. effectiveness of monitoring by owners or supervisory bodies) and on some countries (e.g. developing countries) are not available or subjective. Thirdly, corporate governance systems are dynamic and evolve slowly over time, so that the effects of increased competition on the systems lag behind. Fourthly, international competition between corporate governance systems is a process that has already begun but has still not ended, making assertions with respect to final outcomes impossible.

The aim of this dissertation is to provide new empirical evidence on the outcomes of international system competition in three case countries until 2005. Concentration on few countries is necessary because the systems and their evolution over time are analyzed in order to identify the direction of the changes occurred in the last decades (i.e. convergence or persistence). The central question of the dissertation is “*where is the international competition between corporate governance systems, triggered by globalization, headed in the USA, Germany, and Colombia?*” The advantage of the case

countries selected is that they provide an insight into the institutional framework of other countries because there are only two models of corporate governance and four main legal families in the world. Thus, countries following the same model of corporate governance or belonging to the same legal family exhibit similarities (La Porta et al 1998, p. 28). The USA is a common-law country that follows the Principal-Agent model. Germany is a German civil law country that traditionally followed the Stakeholder model. Colombia is a developing country which does not follow any of the recognized theoretical models and which belongs to the French civil law family. Additionally, previous empirical work on Colombia is scarce.

Two distinctive features of the dissertation are worth mentioning. Firstly, based on modern institutional economics I develop a new framework to study any corporate governance system as a whole. The framework includes employees, who play a fundamental role in corporate governance systems as investors in firm-specific knowledge, controllers of management, and production factors. Previous work on corporate governance has rarely enclosed employees in its analysis. Secondly, within this framework I characterize the main corporate governance institutions at both the national and company levels and study their evolution over time until 2005, working out the role of globalization in the process. Therefore, besides basing on papers, monographs, surveys, empirical works, and statistical figures, I rely on journals' and newspapers' articles as well as on own interviews with policy makers and market participants in order to uncover trends and forces behind the current developments in each case country. In this way, it was possible to assess the direction of the changes which have occurred in the last decades and the influence of globalization in these events.

The dissertation is divided into three main chapters.

In the first chapter, based on modern institutional economics, I identify three conditions that must be fulfilled by a good corporate governance system in order to support economic performance:

1. Balance between the freedom of action and the accountability of management.
2. Access to external capital to invest at low cost.
3. Qualified human resources for firm-specific investments.

These conditions provide a general framework to analyze the multidimensionality of corporate governance. By means of different approaches, the two recognized theoretical models of corporate governance – the Principal-Agent and the Stakeholder models – fulfill the conditions for a “good” corporate governance system and thus support economic performance.

In the second chapter I demonstrate that the internationalization of production and the globalization of goods, service and financial markets can lead governments and companies to alter national corporate governance systems in order to stand out in international competition and maximize domestic social welfare.

In the third chapter, I investigate the particular institutions that traditionally characterized each system and the process of changes these institutions have experienced in the last two decades until 2005. The framework for this review is based on the conditions for a good corporate governance system above-mentioned.

I conclude that the traditional corporate governance systems of the case countries were significantly different and that in the last two decades globalization has indeed instigated the international competition between corporate governance systems. This competition has forced governments and companies to alter traditional provisions and practices in such a way that over the years the corporate governance systems of the USA, Germany and Colombia have been converging at different paces towards a new system that follows the Principal-Agent model and which is similar to the US system.

Chapter 1 - Theoretical Framework

This chapter aims at investigating how corporate governance systems influence economic performance in theory. A corporate governance system is a network of formal and informal institutions that determine the relations between management, the board of directors, shareholders and other stakeholders (e.g. employees, clients, suppliers) in a company. Sound institutions reduce transaction costs and uncertainty by enhancing information flows, reducing information asymmetries and enforcing agreements. Thus, institutions matter for economic performance.

In order to find out the particular channels through which corporate governance systems affect economic activity, I proceed in three steps.

Firstly, the main theoretical problems to which corporate governance has to give responses are identified. These problems are: excessive discretion of management or majority shareholders, and expropriation of shareholders and/or stakeholders.

Secondly, in order to solve these problems a good corporate governance system has to provide the incentives to

1. balance the accountability of management with the freedom of action,
2. guarantee access to financing at low cost, and
3. qualified human resources for firm-specific investments.

Thirdly, it is examined whether the two recognized models of corporate governance – the Principal-Agent and the Stakeholder models – fulfill the above-mentioned conditions by inducing a proper allocation of resources within the firm and by providing the incentives to invest in the firm.

I conclude that relying on a different set of incentives the two recognized models of corporate governance fulfill the conditions for a “good” corporate governance system and thus support economic performance.

1.1 Definition of Corporate Governance

The term corporate governance refers in its narrowest sense to the set of institutional¹ agreements aimed at balancing the freedom of action and the accountability of management towards shareholders (Charkham 1994, p. 4). Issues related to this narrow definition include checks and balances on the exercise of power, election of accurate

¹ North defines institutions as “the rules of the game in a society or, more formally, the human devised constraints that shape human interaction” (North 1996, p. 3). Institutions are divided into formal and informal. Formal institutions comprise of political, judicial and economic rules and contracts, whereas informal institutions include customs, traditions and codes of conduct. Due to their own character, formal institutions can be modified or created rapidly (e.g. the passing of a law, resolution or even the constitution), while informal institutions evolve slowly over time.

management, timely appropriate transfer of power, proper managerial remuneration, and the balance between confidence and humility of management.

In its broadest sense, corporate governance refers to the network of formal and informal institutions that determine the relations between management, the board of directors, shareholders and other stakeholders (employees, clients, suppliers, the government and public interest groups such as the community) in a company (Mehran 2001, p. 1). This definition encloses the narrowest definition and expands the topics studied to the participation of stakeholders in company decisions and monitoring activities (e.g. labor participation, governmental intervention, involvement of banks, social responsibility of the firm). Corporate governance provides the framework for setting objectives, monitoring performance and distributing risks and returns in a company. The objectives are improvement of management and supervisory structures, successful operation and long-term value of companies.

Corporate governance does not occur in a vacuum, but rather in a network of formal and informal institutions, which comprises of corporate law, labor law, regulations of capital markets, bankruptcy law, stock exchanges, watchdogs, the judicial system, the financial system, codes of conduct, and corporate practices (Witt 2003, p. 117, 118). These networks are called corporate governance systems and refer to a territorial entity, where these institutions exist or are applied and an own cultural background exists (i.e. a state or a country). Hence, corporate governance systems vary from country to country, set the incentives for economic activity and are dynamic since they evolve over time through the interaction with organizations², such as companies and interest groups.

Corporate governance is of capital importance because companies are powerful both in the economic and political spheres; some multinationals (e.g. Toyota, General Electric, Exxon, Siemens) have earnings that surpass the GDP of sovereign states (Charkham 1994, p. 2). Hence, the decisions taken by management have an impact on the economy as a whole (i.e. investments, innovation, employment, tax payments). Moreover, by undermining confidence of agents, unethical behavior of management, as seen in recent corporate scandals, may have domino effects on the capital market and the financial system, threatening the stability of the economic system.

The practical problems of corporate governance are studied by modern institutional economics, which is the subject of the next section.

1.2. Modern Institutional Economics

Institutions, such as corporate governance, become relevant for economic analysis when two main assumptions of the neoclassical model are levied: perfect information and foresight, and costless transactions.

First of all, in the absence of perfect information and foresight, the agents stand in a world characterized by uncertainty and asymmetric information. Uncertainty about future events and about the patterns of response of other agent means that information is incomplete (i.e. information is not available or does not exist at all). Incomplete information turns the decision making process of agents difficult since acquiring, processing, organizing and utilizing information is costly and complex. Thus, agents have bounded or limited rationality (Furuboth and Richter 2000, p. 4). To counteract the effects of uncertainty, individuals establish predictable and regular patterns of behavior, such as rules and procedures, in other words, formal and informal institutions (North 1996, p. 25).

Akerlof (1970, p. 489-491) explains the effects of asymmetric information considering as example the market for “lemons” or the market for used cars in the United States. Due to the fact that in most of the cases sellers know the quality of the cars better than buyers do and that it is prohibitively expensive to examine the attributes of the cars offered on the market for used cars, both good and bad cars are sold at low prices. In this context, moral hazard or the incentive to take advantage of superior information (e.g. by hiding relevant information in the exchange process) undermines exchange activity on the market. Potential buyers or sellers of higher quality products or services will avoid to trade on the market because it is probable for sellers to get low prices for good products and for buyers to get bad products. Institutions, such as guarantees for products and services, information about potential buyers and sellers, brand-name goods, restaurant or hotel chains, and certifications for qualifications, can solve or minimize adverse selection, and thus support market exchange by enhancing transparency.

Secondly, transaction costs are defined as the costs of measuring the valuable attributes of what is being exchanged, the costs of protecting rights, and the costs of policing and enforcing agreements (North 1996, p. 27). The costs of measuring attributes depend on the availability and cost of information. The protection of rights and enforcement of agreements is critical when at least one of the parties committed has the incentive to break the agreement or violate established laws. In this case, the transaction cost will

² Organizations refer to the people behind the institutions or the “groups of individuals bound by a common purpose to achieve an objective”. Organizations are political, economic, social and educational bod-

include a risk premium that signals the probability of defection of the parties. This risk premium will depend on the quality of institutions to enforce rights and agreements. Hence, low transaction costs are associated with low corruption, observance of rules, payment of obligations and the minimization of moral hazard and free-rider problems. In such an environment, cooperative outcomes, which solve prisoner's dilemmas and free-rider problems, with returns that surpass the market returns are more likely to materialize. In analogy, sunk investments in human and real capital, which support a higher degree of specialization of the production associated with higher value-added, are more prone to be undertaken.

Furthermore, Coase (1937, p. 388-397) explains that transaction costs and uncertainty impede that all economic exchange is settled on the market. There are additional methods to allocate resources, like managerial decisions. For example, in case of a firm-specific investment, where it is costly or impossible to assert the real price of the good and service *ex ante*, or in case of the long-term supply of some article and service, where the characteristics of it vary over time but are unknown *ex ante*, the costs of providing these goods or services inside the firm can be lower than on the market. The network of such firm-specific investments is the economic core of the firm; it determines the activities undertaken and the size of the firm. The marginal returns of allocating resources within the firm are decreasing because the costs of doing an extra transaction increase due to information constraints and higher costs to coordinate and monitor resources. Thus, there is a point where the cost of organizing a new transaction within the firm equals the cost of contracting it on the market. From this point on it is optimal to contract on the market and not to expand the firm, setting the limits to the firm's organic growth and thus determining the firm's size. As a result, the task of management is not confined to selecting profit-maximizing quantities of outputs and inputs as asserted by neoclassical theory, but it also involves dealing with uncertainty, incomplete information and transaction costs in order to evaluate products and market chances, to manage employees, allocate other resources, and to undertake investments within a given institutional framework.

In sum, institutions provide the framework for economic activity (i.e. regulations, enforcement of laws, protection of rights) and set the incentives for investment in human and real capital (i.e. support of certain branches, skills and knowledge of the population), which are the underlying determinants of economic growth.

ies such as firms (North 1996, p. 5)

Regarding corporate governance, modern institutional economics focuses on three main subjects: incomplete contracts, the principal-agent problem and enforcement of agreements and rights. These three topics are explained in the next three sections.

1.2.1. Incomplete Contracts

Incomplete contracts refer to the impossibility to specify *ex ante* the potential responses to all future events in an environment characterized by uncertainty. Even contracts which incorporate the most complex and detailed rules that can be monitored and enforced at low costs cannot be complete since expectations can be misled by *ex ante* unknown coming incidents. As a contract is not able to incorporate the inconceivable one or more contracting parties have to be granted freedom to make decisions in situations not covered by the initial contract (i.e. discretion or, more formally, the residual right to control) (Ezzamel and Watson 1997, p. 58).

Especially interesting from the corporate governance perspective is how the discretion conferred by incomplete contracts can be better channeled to enhance performance and long-term value of the company. This section confines to giving examples of the kinds of contracts that provide a great extent of discretion, whereas section 1.4 presents two theoretical models that minimize the abuse of discretion of the parties involved through different means.

Executives play a central role because they have to employ their skills, experience and judgment to manage resources and to make and implement decisions regarding strategies, investments and financing plans. These activities are bound to outcomes that cannot be anticipated *ex ante* and hence executives are normally granted a great scope of freedom to undertake their duties adequately by allocating investors funds. However, in the absence of institutions that hold executives accountable for their behavior, discretion might be abused. There are several forms in which managers can expropriate returns of investors (i.e. creditors, shareholders, employees, suppliers). The simplest way to shirk is to abscond with the money. Managers may also indulge in excessive consumption of perquisites, follow an “empire-building strategy”³ or adopt a harmful risk-averse attitude towards corporate investment decisions. Furthermore, they can divest funds to companies that they own personally by selling assets and/or output of the main company to their company at below market prices. Finally, they can entrench themselves and stay on their job even if they are no longer competent or qualified to run the firm.