Globalization and the Evolution of Corporate Governance

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Abstract

How does globalization affect the balance of power between managers and firm owners? This paper studies the effect of economic integration on governance practices within firms. I propose a theory of endogenous corporate governance investments in industry equilibrium with monopolistic competition. Firms can use investments into better corporate governance as a cheap substitute to performance compensation to mitigate agency problems. International integration alters the demand for managers in the economy such that firms may reduce their corporate governance investments and offer higher performance payments. This globalization-induced deterioration of corporate governance in the economy diminishes the welfare gains from globalization. Using data on governance practices in U.S. manufacturing corporations, I provide empirical evidence that conforms to the model predictions. Firms in industries that experienced substantial trade liberalization between 1990 and 2006 have changed their governance practices allowing for more managerial slack and offered higher equity payments to their CEOs. These effects are particularly large in relatively dynamic industries that are characterized by large exit rates.

JEL Classification: F12, F16, G34, L22

Keywords: agency problems in international trade, endogenous managerial entrenchment, corporate governance and CEO compensation