Is Corporate Governance a First Order Cause of the Current Malaise?

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“The Current Malaise”

- 1. Inequality
- 2. Economic Insecurity
- 3. Slow Economic Growth

Throughout the OECD.

“Corporate Governance”

- Meaning: allocation of decision-making power and influence within the corporation; in particular (and especially in the US), the extent to which (and the means by which) shareholders exercise power.
- “Corporate governance” is not static: difference corporate governance systems could evolve on the top of legal regimes that are relatively stationary (Gilson, 2018).

Is Corporate Governance a First Order Cause: The Financial Crisis

- Failures in corporate governance were (correctly) seen as major cause in the financial crisis. General focus on shareholder wealth maximization, including high-powered stock-based incentives for senior managers, was ill-suited to systemically important financial firms. This is because the consequences of failure are "systemic," meaning that shareholders and other parties in direct privity will pursue/permit risk-taking in excess of the social optimum. The optimal failure rate of SIFI's is zero; a risk-promoting corporate governance model is inconsistent.
- BUT: post-crisis reforms for financial firms have principally pursued substantive regulatory solutions, not corporate governance reforms: balance sheet tests; activity constraints; efforts to reduce systemic consequences of failure

“First Order Cause”: the Malaise

- Common to identify “Globalization” as a “first order cause.”
- Eg, Lakner and Milanovic (2016) (“Elephant Chart”); Milanovic (2016) (“Global Inequality: A New Approach for the Age of Globalization”)
- Globalization: trade liberalization + capital market fluidity
- Meaning: -- greater product market pressure

  -- more flexibility in sourcing production; supply chain creation and management

  -- aggregation of capital into hands of institutional investors, looking for highest global returns, with shareholder focus

"First Order Cause"

- Corporate governance is the transmission mechanism of these product market and capital market pressures to the operation of the firm, including the distribution of economic rents among the potential claimants at the firm level, the shareholders, the managers, and the employees
- Different models of corporate governance conceivably could transmit these pressures differently.

Summary of corporate governance effects in the US: Income Inequality

- 1. Weak corporate governance has exacerbated income inequality through the compensation channel

(i) Through excessive executive compensation delivered through stock options and other stock-based compensation by boards with limited monitoring capacity

-- "pay for performance" delivered through stock options conflates two distinct functions: (1) incentives (2) reward (profit-sharing).

-- As "incentives," conditioned on readily observable signal (stock prices) stock options merely replicate a signal that directors could use even with fixed pay and credible threat of termination.

-- As reward (profit-sharing), costly to shareholders

(ii) "Golden parachutes" that provide for bonanza payoffs for target managers in m&a and in disciplinary dismissals, "pay for failure"

Weak governance=> excessive compensation lock in

(iii) In earlier "weak governance" period, creating distortions in the market for managerial services that are locked-in through path dependency. Bargaining now "at arm's length" comes against the backdrop of prior distortions.

-- E.g., golden parachutes: mechanism for shareholder repurchase of takeover resistance endowment granted to management by Delaware courts in a weak governance period.

-- But persists despite much stronger governance

Summary of corporate governance effects in the US: Income Inequality, 2

- 2. Deficient corporate governance has exacerbated income inequality through the Private Equity channel

  -- Relative gains of top 1% are linear; of top .1%, or .01%, are exponential.

    -- Tax data shows that income of top .01% comes from pass-through entities, i.e., PE firms, Hedge Funds

  Channel: "Take Private" (or "Stay Private") model partly results from limitations of Public Company governance model, which features directors who are "thinly-informed" and "under-resourced" to provide credible monitoring for firms with plans that can not be revealed for competitive reasons or "complex" plans that require expert evaluation.

Summary of corporate governance effects in the US: Income Inequality, 3

- PE/Inequality Channel (continued): Given current governance pressures (below), managers may choose sub-optimal strategy.
- PE/Take Private provides governance space for pursuit of optimal strategies. BUT: gains are concentrated among PE partners (the .01%).
- A better Public Company governance model (opt-in to "Board 3.0" – empowered, well-resourced directors) would enhance financial inclusion/reduce inequality to redistribution of enhanced performance

Summary of corporate governance effects in the US: Economic Insecurity

- Channel: the Rise of "High-Powered Corporate Governance": the strategies/mechanisms by which shareholders (increasingly, institutional owners) have insisted on "efficiency" (from shareholder point of view)
- 1. Hostile Tender Offers, 1970s, 1980s (overcome "rational apathy"/free-riding that impeded shareholder "voice" as a disciplinary mechanism)

-- Produced "governance externalities": the main reason for the virtual disappearance of hostile bids (not "Just Say No")

-- Prior to hostile bids, firms could run with considerable "slack" from shareholder point of view, at a level that could make a hostile bid profitable even with a 40% premium

Summary of corporate governance effects in the US: Economic Insecurity, 2

--To avoid being targeted, managements (and boards) followed slack-reducing strategies

--Biggest impact of hostile bid movement was though such the "external effects," changing the way public firms were run

- Important channel for reducing slack: down-sizing the labor force, closing marginal plants and facilities

Summary of corporate governance effects in the US: Economic Insecurity, 2

- 2. Shareholder activism, 2000s-present

  Reconcentration of ownership in institutional investors opens the way for exercise of shareholder voice, potentiated by activist investors

  -- Change in ownership concentration means activists can develop a "reputation" and shareholders can be mobilized

  -- Consequence: firms operating with lower level of "slack" can be targeted

Once again: -- To avoid being targeted, managements (and boards) followed slack-reducing strategies

--Biggest impact of hostile bid movement was though such the "external effects," changing the way public firms were run

- Important channel for reducing slack: down-sizing the labor force, closing marginal plants and facilities

Summary of corporate governance effects in the US: Economic Insecurity, 3

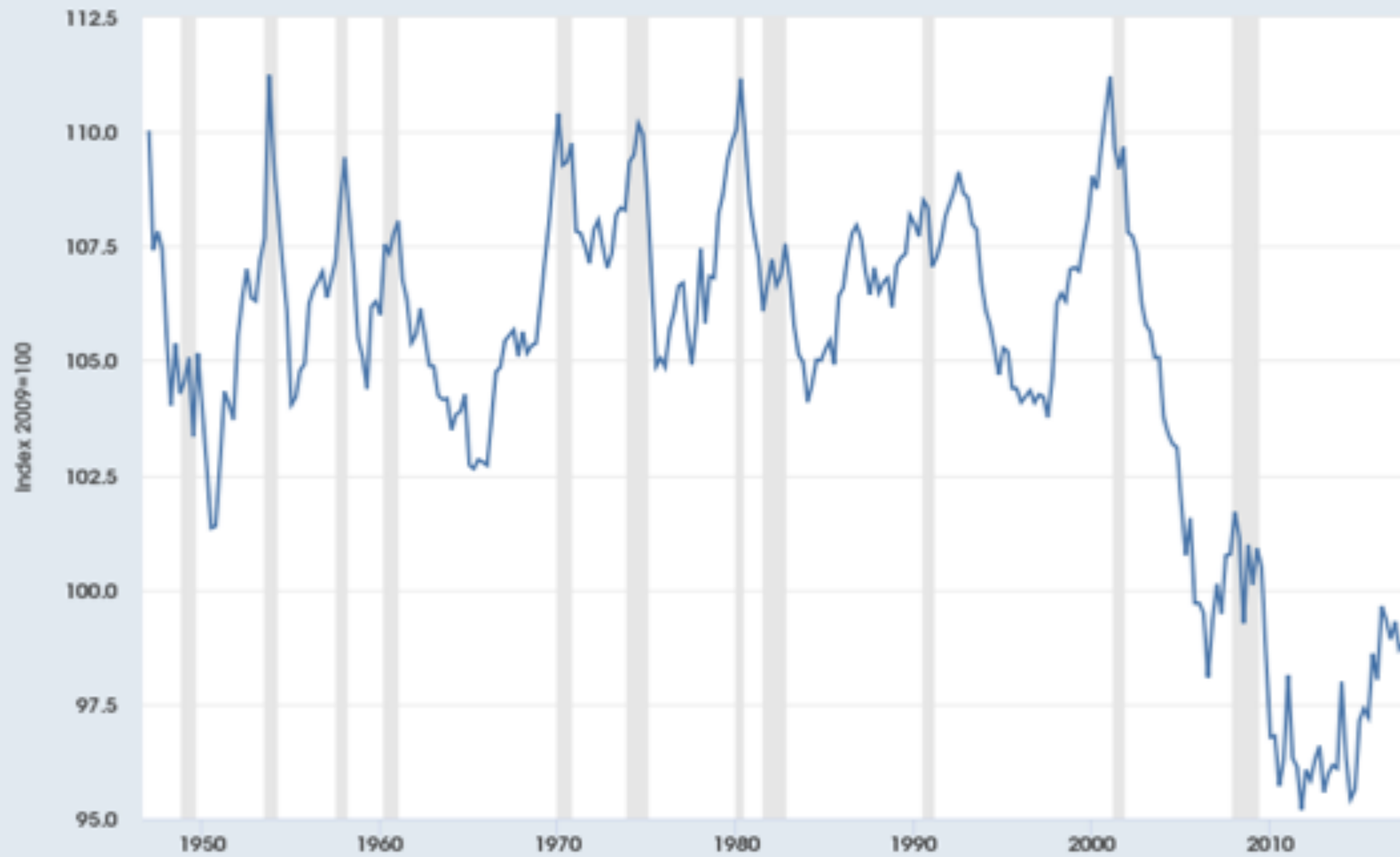
- Consequence: Economic instability from "Displacement"

  Classic theory about "job loss": frees up human resources that can be put to higher and better use

  Empirical effects: "Displacement" on average leads to permanent decline in wage levels (firm specific investments are lost; exacerbation if dominant employer in the region; mobility frictions; diminishing regional convergence)

  Economic insecurity may have significant effects on wages: competitive environment and rapidity of translation into down-sizing constrains concerted activity (declining unionization) and even local "asks"

Economic Insecurity => Declining Labor Share?



FRED
Nonfinancial Corporations Sector: Labor Share
112.5
110.0
107.5
105.0
102.5
100.0
97.5
95.0
Index 2009=100
1950
1960
1970
1980
1990
2000
2010
Shaded areas indicate U.S. recessions
Source: U.S. Bureau of Labor Statistics
myf.red/g/k1JX

Alternative/Additional Hypotheses

- Alternative/additional hypothesis: “Economic Insecurity” is a consequence of external events, e.g., China trade shocks.
- EG: Assume an “industrial district” in textiles:
  - the presence of many firms strengthens all: supplier/customer networks; innovation networks; job mobility among firms.
  - Relative competitive success, including local firm failures, would entail mild disclocations
- “China trade shock” affects the entire district

Corporate Governance Still a Cause?

- Economic Insecurity/displacement; diminishing labor share is not sectorally limited to areas of sudden trade effects.
- Pervasive technological change and innovation establishes the economic environment
- Nevertheless, Corporate Governance determines how immediate firm-level adjustment costs are divided up among shareholders, managers, and employees.
- Eg, assume technological innovation diminishes the value of human capital investments. Corporate governance determines the speed of the “write down”

Risk-Bearing/Risk-Shifting

- High-Powered Corporate Governance has shifted the relative risks borne by shareholders vs. employees
- Financial markets developments have *reduced* firm-specific (idiosyncratic) risks borne by shareholders
  - (i) theory of diversification
  - (ii) development of low cost providers of diversified portfolios
- But same development have *increased* firm-specific risk borne by employees
  - (i) diversified shareholders encourage greater risk-taking by individual firms, imposing bankruptcy risks on employees;
  - (ii) institutional investor responsiveness to activists is key element of High-Powered Governance Model, producing governance externalities, focus on reducing slack

Summary of corporate governance effects in the US: Slow economic growth

- Claim: Corporate governance channel: focus on shareholder returns of High-Powered Corporate Governance model (see above) results in under-investment (CAPEX and R&D); "short-termism"
- Channel: return of capital to shareholders through stock buy-backs rather than internal investment
- Rebuttal by way of empirics: Low-cost (extra-ordinarily low-cost) debt is readily available to fund projects; replacing equity with debt does not entail sub-optimal investment. See also Roe (2018)
- Rebuttal by way of empirics: High market tolerance for firms with zero payouts that successfully reinvest and are highly innovative: Amazon, Apple, Google, Walmart

Corporate governance as a factor in slow economic growth?, 2

-- The “long termism” of such firms has been highly disruptive of prior retail sales arrangements and prior technology leaders

-- “Right termism” for a firm varies by competitive environment and other firm specific factors.

EG, Apple’s product cycle for a new iPhone vs. GE’s for a new jet engine or gas turbine

Alternative hypothesis: Slowing pace of real innovation (R. Gordon 2016)

Alternative hypothesis: Government short-termism. Impact on corporate planning of potential currency breakdown (the Euro); trade-disruptions and sudden stops in talent flow (Brexit); potential supply-chain disruptions (US turn to economic nationalism, neo-mercantilism)

Corporate governance as a factor in slow economic growth?, 3

- Alternative hypothesis: Governments' post-crisis policy failure in pursuing austerity.
- Thus: Looking to firms' cash reserves as source of privately-supplied Keynesian stimulus

High-Powered Corporate Governance => Kaldor-Hicks only?

- Shareholders have done well; managers have done well; PE has done exceptionally well; general economic well-being (even at time of historically low unemployment), “meh”
- Has the “Efficiency” of High-Powered Corporate Governance failed to deliver a distributionally acceptable outcome?
- Corporate governance: has a role in creating first order problems
- Solutions within corporate governance; solutions by government
- A new role for asset managers?

Solutions within corporate governance

- 1. Improving public company governance: Board 3.0 option for financial inclusion (see above).

  --Valuable but limited range

- 2. Role of institutional investors, especially large asset managers

  What exactly would that role consist of (beyond supporting Board 3.0)

  What is the content of "Stewardship"?

Objective function of Asset Managers

- Their product: diversified portfolios.
- For a broad range of products, the only risk is systemic risk.
- To improve outcomes for clients/customers:
  (i) improve performance of the economy as a whole;
  (ii) and/or: reduce systemic risk
- Does "stewardship" have as its agenda improving performance across the economy? Will this be achieved by an admonition for each company to articulate its "strategic framework for long-term value creation"? [L. Fink letter to CEOs, Feb. 2018]

Objective function of Asset Managers, 2

- What about reducing systemic risk?
- High-Powered Corporate Governance, efficiency focused, slack-minimizing, has contributed to high adjustment costs
- Adjustment costs that are large, widespread, and persistent, may put social and political stability at risk.
- To lower systemic risk: focus on stability as well as efficiency?
- But: ordinarily systemic risk reduction requires coordination among firms, even mandated, because of free-rider problems
- "Stability" is a property of systems (think banking), not own-firm decision-making, the domain of corporate governance

Reframing Economic Instability as an Insurance Problem: Insurance demand/market failure

- Problem of economic instability (as exacerbated by High Powered Corporate Governance) is an insurance failure
- Firms are unable to provide the insurance employees would desire, either directly or through third parties
- Directly: deferred compensation as the premium?
  - How to set premium given (i) changing business risks;
  - (ii) cross-sectional variation within employee groups and over time on relative risk exposure/risk-bearing capacity?
  - (iii) variation in optimum payouts: salary replacement (subject to co-insurance) vs. retraining/human capital renewal, other adjustment assistance

  --Subject to shareholder opportunism? Transactions that reduce capacity of firm to make insurance payouts.

  --Subject to Business reversals that undermine the firm’s capacity to make payouts

Firm-level displacement insurance?

Protecting the Firm-level Insurance Promise

-- Separate Funds, like Defined Benefit Pension Plans (reinvestment risk? Assumed rates of return?)

-- Third Party Insurers (Moral Hazard risks)

BIG Problem: If left to single firm choice, consequence could be adverse selection effect in employee recruitment

Market failure: government role

- Government can provide insurance that no single firm can provide
- Insurance solutions: not just better risk-sharing or redistributive ("fairness"), but facilitates conservation/higher valued use of scare human resources
- Helps address Slow Economic Growth

Reframe: Government “match”

- Alternatives way to conceive of government role is new form of government/private sector match
- No one would think for firms to provide basic education to employees: core training is socially provided. Government facilitates “start up” acquisition of human capital
- In an economy where competitive factors will likely impose continual adjustment costs, Government match may now include support for on-going acquisition of human capital
- Facilitates growth and productivity; augments employee bargaining power by strengthening outside options

Asset managers redux

- If welfare of customers of systemic-risk bearing clients can be improved by only by improved economy-wide performance or by systemic risk reduction, what are the demands of “stewardship”?
- If genuinely active, not “passive,” what are the boundaries of activism where welfare enhancement requires collective action?