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

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Summary of Paper

• **Problem:** Current malaise:

  1. Inequality – (a) increase in executive compensation (b) gains of private equity (c) labor share decreasing
  2. Economic insecurity
  3. Slow economic growth

• **Potential cause:** Increased institutional ownership which monitor to a limited extent. Corporate governance of public firms, i.e., allocation of decision making power within organizations.

• **Solution:** Increase government intervention. Require reallocation of corporate profits, to update the skills of employees.
1a. Executive Compensation: Optimal Contracting or Extraction of Rents?

Where does the paper fit, and how does it contribute relative to the prior literature on executive compensation?

• Contracting is optimal – agency theory (Jensen and Meckling (1976) Grossman and Hart (1983)). Shareholder design optimal contracts representing their interests.

• Extraction of rents – CEO set to a great extent their own compensation, limited by the “outrage cost”. (Bebchuck and Fried, 2004.

Possible contributions: ownership and government policy.
Whose Interests are CEOs Representing?

Data from Hadlock and Schwartz-Ziv (2018)

- More financial institutions, but no increase in block ownership.
- Decrease in non-financial block.
- Private equity and hedge funds constant.
- Mutual funds hold hundreds of investment.
- Fragmented shareholder structure: Fewer blocks, more index funds, dispersed shareholder within institutions.
- Leads to a severe coordination problem and increases the agency conflict.
The major investment managers devote less than one person-workday for governance (Bebchuk, Cohen, and Hirst, 2017).
1B. Private Equity Compensation

- Is the concern that private equity funds earn at the expense of other shareholders, or that they design non-optimal incentives?

<table>
<thead>
<tr>
<th></th>
<th>Total compensation (1)</th>
<th>Value of options awarded (2)</th>
</tr>
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<tbody>
<tr>
<td>Total fraction of shares held by committed blockholders</td>
<td>-1046.4451</td>
<td>-110.5871</td>
</tr>
<tr>
<td>Total fraction of shares held by financial blockholders</td>
<td>-880.1846***</td>
<td>-50.6697***</td>
</tr>
<tr>
<td>Total fraction of shares held by private equity / hedge funds</td>
<td>1778.1912***</td>
<td>169.6013***</td>
</tr>
<tr>
<td>Company controls</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.295</td>
<td>0.138</td>
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<tr>
<td>N</td>
<td>22,931</td>
<td>7,302</td>
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7.3% increase relative to the mean
1C. The Labor Share

Decreased Slack vs. Increased Agency Problem?

• Organization have been running with decreasing levels of slack

• “The “labor share” of enterprise rents has been declining for more than 25 years in the United States. It used to be the case that US corporations could run with 50% or more slack ... evoked hostile bids... A similar process is underway in the wake of shareholder activism. Firms that formerly ran with 20% slack, for example, are now vulnerable to activists who are prepared to intervene to obtain returns of 10%.”

• Does a decrease in labor share mean that companies slack decreases? Perhaps the problem is further exacerbated because CEOs are able to extract more rent at the expense of the median employee?
Decreased Slack vs. Increased Agency Problem?

US Labor Share

Layoffs and Discharges
https://fred.stlouisfed.org/series/JTSLDR

CEO Pay Growth

- Some evidence on decreased slack would be useful.
Optimal Solution?
Institutional or Concentrated Ownership

• Dispersed ownership (CEO can extract rent).
• Concentrate ownership (large shareholder can extract rent).
Solution—Should Government Intervene?

How is CEO Compensation Negotiation Different from that of the Median Employee?

CEO compensation negotiation

Employee compensation negotiation
What happens When the Government Intervenes?

- Examine a recent legislation change in Israel that created a dramatic restriction to the compensation for a subset of Israeli firms.

- Authors find a significantly positive abnormal returns (1.58%) in a short-term event window around the passage of the law. This effect is concentrated among firms bound by the restriction.

- As time passes, this setting will allow to address additional important questions: Did these companies suffer from executive turnover? Are they able to recruit less qualified managers? Is long term performance affected?
Summary and Conclusion

• Paper addresses very important question.

• Highlight the contribution of the paper given existent studies.

• If possible, provide empirical evidence.

• Perhaps the paper can offer additional possibilities of how the government can enhance a more efficient environment, perhaps inspired by experiences of specific countries.