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Labor protection and government control: Evidence from privatized firms☆

Hamdi Ben-Nasr

College of Business Administration, King Saud University, Saudi Arabia

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ABSTRACT

In this paper, we examine whether labor protection determines the decision to retain a golden share in privatized firms. Using a sample of firms privatized in developing and industrialized countries, we find a negative relation between the likelihood of observing a golden share and labor protection. However, we find that this relation does not hold in the post-financial crisis period, suggesting that the recent crisis is associated with an increase in government control. Furthermore, we show that privatized firms in countries with strong labor protection are penalized with a higher cost of equity. Overall, our results underline the importance of labor protection for an important government control mechanism, namely golden shares, as well as for equity financing costs of privatized firms.

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1. Introduction

Privatization can be defined as the sale of state-owned enterprises (SOEs) or assets by a government to private investors. The transfer of ownership and control rights from a government to private investors is associated with a reduction of political interference, hence greater emphasis on profits and efficiency (Boycko et al., 1996; Shleifer and Vishny, 1994). Consistent with this point of view, several papers show that privatization enhances corporate efficiency (e.g., Boubakri and Cosset, 1998; Boubakri et al., 2005; Dewenter and Malatesta;, 2001; Djankov and Murrell, 2002; Estrin et al., 2009; Gupta, 2005; Megginson et al., 1994; Omran, 2009). Although privatization should be accompanied by the suppression of political ties between the state and the firms concerned, recent empirical studies show that governments continue to influence privatized firms, exerting direct influence by holding shares in them. Bortolotti and Faccio (2009) show that governments remain the largest shareholder in privatized firms from OECD countries even several years after privatization. In the same vein, Boubakri et al. (2011) show that governments continue to be shareholders in privatized firms from emerging markets. Governments can indirectly influence partially or even fully privatized firms through golden shares. A number of empirical studies document the presence of golden shares in privatized firms. Using a multinational sample of privatized firms, Jones et al. (1999) find that governments impose control restrictions on the firms' charters or retain golden shares in the vast majority of their sample firms.[1] Similarly, Bortolotti and Faccio (2009) document the use of golden shares in privatized firms from OECD countries.

In this paper, we examine whether labor protection determines the decision to hold a golden share by the government in privatized firms. Labor protection may affect government control in two ways. First, privatization is usually associated with labor restructuring (Boycko et al., 1996). For instance, several studies (e.g., Ramamurti, 1997; La Porta and Lopez-de-Salines, 1999; D'Souza and Megginson, 1999; Laurin and Bozec, 2001; Omran, 2001; Boardman et al., 2003; Sun and Tong, 2003; Okten and Arin, 2006; Chong et al., 2011, among others) show that privatization leads to retrenchment of employees. Other studies show that privatization is associated with an increase in the number of working hours (e.g., Shaikh, 1996). Given that, governments may privatize less and maintain control; when they face stringent employment protection that imposes restrictions on employee layoffs and wages reductions. This point of view suggests that the government is more likely to issue golden shares to continue to protect employees in the presence of strong labor protection. Second, stringent employment protection may reduce the risk of layoffs and wage reductions after privatization, hence it may lower labor union opposition to privatization (Subramanian and Megginson, 2012), hence encourages control relinquishment. In addition, prior literature (e.g., Gupta, 2005; Boubakri et al., 2008, among others) reports evidence suggesting that less labor restructuring is expected when the government maintains the control of the privatized firm. Given that, we expect that the government is less

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E-mail address: hbennasr@ksu.edu.sa.

[1] Jelic and Briston (1999) and Jelic et al. (2003) document also the presence of golden shares in transition economies.

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likely to retain a golden share in privatized firms from countries with strong labor protection, since there is less need to maintain control in order to protect the interests of the employees. In this study, we empirically test these two points of view. This test is timely and important. In fact, the recent financial crisis is accompanied with an increased government participation in bailed out firms. It can also push governments to use golden shares in order to safeguard national security. Given that, it is very important, to know about golden shares as a mean of maintaining control.

Using a multinational sample of privatized firms from developing and industrialized countries for the period from 1985 to 2012, we find that the government is less likely to retain a golden share in privatized firms from countries with stronger labor regulations, consistent with the conjecture that stringent employment protection may reduce the risk of layoffs and wage reductions after privatization, hence may lower labor union opposition to privatization (Subramanian and Megginson, 2012) and encourages control relinquishment. This finding remains robust when we address the endogeneity of labor protection using 3SLS approach, control for state ownership, privatization size, and additional country-level variables, and the use of alternative samples. We also find that the relation between golden shares and labor protection is affected by the recent financial crisis. Specifically, we find that the negative relation between labor protection and golden shares dummy does not remain negative after the crisis, suggesting that the latest financial crisis is associated with an increase in government control. We also find that our results remain qualitatively unchanged when we regress our labor protection model separately for firms from emerging/developing countries and firms from developed countries. We extend our analysis of the impact of labor protection on government control by examining the economic outcomes of labor protection for privatized firms. We find strong evidence that labor protection is associated with a higher cost of equity, consistent with the conjecture that strong labor protection is associated with higher labor adjustment costs, hence lower operating flexibility. We also find that the adverse effects of labor protection on the cost of equity are less pronounced in firms with a golden share.

Our study is mainly related to two strands of literature. The research questions, sample, Methodology and results and conclusions of these literatures are summarized in Table A1. First, our paper is related to the literature on the impact of labor protection on corporate decisions and outcomes (e.g., Besley and Burgess, 2004; Henin and Weitzenblum, 2005; Kanniainen and Vesala, 2005; Autor et al., 2007; Lingens, 2007; Bassanini et al., 2009; Acharya et al., 2010; Botero et al., 2004; Faleye et al., 2006; Atanassov and Kim, 2009; Klasa et al., 2009; Parello, 2011; Chen et al., 2012; Subramanian and Megginson, 2012; Belkhir and Ben-Nasr, 2014; Calcagnini et al., 2014. Our study complements these studies by showing that labor protection determines an important privatization decision, namely the decision to relinquish control. Second, our paper is related to the literature on the determinants of privatization (e.g., Bortolotti et al., 2001, 2003; Bortolotti and Pinotti, 2008; Bortolotti and Faccio, 2009; Boubakri et al., 2011; Dinc and Gupta, 2011). Our paper contributes to this strand of literature by showing that apart from the political, legal, and economic factors identified in abovementioned literature, a country's labor protection determines the decision to relinquish control in privatized firms. Our study is also related to the studies that directly examine the impact of labor protection on privatization. For example, Subramanian and Megginson (2012) examine the impact of employment protection laws on the number and the value of privatization deals in OECD countries. They show that stringent protection laws (EPL) is negatively related with the number of privatizations as well as the privatization proceeds. More recently, Belkhir and Ben-Nasr (2014) investigate the effect of labor protection on the choice of the privatization method (i.e., share issue privatizations (SIPs) versus asset sales)). Using a large sample from 55 developing and developed countries, they show that SIPs are less likely in countries with strong labor protection. This finding is consistent with the argument that the government is less likely to use SIPs in the presence of strong labor protection because it is associated with lower labor adjustment costs relative to asset sales. Our study complements these studies by showing that labor protection determines an important privatization decision, namely the decision to relinquish control.

The structure adopted for the remainder of this paper is as follows. Section 2 describes the sample, provides descriptive information about golden shares and defines our variables. Section 3 reviews the related literature and develops our hypotheses. Section 4 presents the results of our univariate and multivariate tests for the impact of labor protection on golden shares. Section 5 discusses the results of our labor economic outcomes analysis. Our findings and conclusions are summarized in Section 6.

2. Related literature and hypotheses

2.1. Related literature

Our study is related to the literature that investigates the impact of labor protection on economic performance. For instance, several studies examine the relation between employment protection and productivity. Besley and Burgess (2004) report evidence for Indian firms suggesting that stringent employment protection hinders productivity. Similarly, Autor et al. (2007) report evidence suggesting that high dismissal costs in the US are associated with a lower productivity. Lingens (2007) examines the growth effects of union wage bargaining within an expanding product variety growth model. The results of this study show that unions capture monopoly profits and thus give rise to a hold-up problem, which reduces research incentives, hence dampens growth rate. Also, they show that unionization changes the “de facto” skill abundance of the economy, which may be growth enhancing. In the same vein, Bassanini et al. (2009) show that layoff restrictions in OECD countries reduce productivity. In a related study, Acharya et al. (2010) examine the impact of US labor laws on corporate innovation. They provide evidence suggesting that high dismissal costs promote innovation, hence enhance economic growth. Other studies examine the impact of the rigidity of labor regulations on employment level. Stringent labor protection is associated with less job creation and reduces employment (Lazear, 1990; Ljungqvist and Sargent, 1998). Consistent with this point of view, Botero et al. (2004) examine the impact of labor market regulations through employment laws, collective bargaining laws, and social security laws on employment. Using a worldwide sample of firms from 85 countries, they show that stringent labor regulations are associated with a larger unofficial economy, lower labor force participation, and higher unemployment. Henin and Weitzenblum (2005) show that employment protection is effective to reduce unemployment rate in response to business cycle shocks. However, they show that employment protection is ineffective to preclude the impact on unemployment of permanent changes in financial conditions. Parello (2011) develops a no-shirking model of innovation-based growth and examine the impact of labor market policies (LMPs) on innovation and employment. The results show that LMPs can increase innovation and manufacturing employment.

Another strand of the literature studies the effect of employment laws on corporate finance and outcomes. Atanassov and Kim (2009) investigate the joint role of labor and investor protection in determining corporate restructuring decisions. Using a sample firms from 41 countries, they show that strong labor protection is associated with a higher value-reducing asset sales likelihood, especially in countries with weak investor protection. Faleye et al. (2006) report lower new capital expenditures and less risk appetite for firms where employees have a greater voice in corporate governance. These findings suggest that firms in which workers have weight in corporate governance tend to adopt strategies that do not maximize firm value, which leads to higher financing costs. Consistent with this argument, Chen et al. (2012) find that strong labor union is

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