

Wage-setting institutions and corporate governance[☆]Matthew Dimick^a, Neel Rao^{b,*}^aSUNY Buffalo Law School, 618 John Lord O'Brian Hall, Buffalo, NY 14260-1100, United States^bSUNY, Department of Economics, University at Buffalo, 423 Fronczak Hall, Buffalo, NY 14260-1100, United States

ARTICLE INFO

Article history:

Received 31 May 2015

Revised 4 January 2016

Available online 26 January 2016

JEL Classification:

G34

K22

K42

Keywords:

Corporate governance

Bargaining centralization

Wage-setting institutions

Legal origin

Labor movements

ABSTRACT

Dimick, Matthew, and Rao, Neel—Wage-setting institutions and corporate governance

We present a model in which wage-setting structures explain cross-country variation in corporate governance. The model predicts a nonmonotonic relationship between the level of centralization in wage-bargaining institutions and the levels of firm ownership concentration and investor protection legislation. Low and high degrees of centralization yield less concentrated ownership and more investor protection than intermediate degrees. Like recent research, this paper highlights labor as a key constituent in shaping corporate governance. However, our theory can resolve an important puzzle this research confronts, namely, why Scandinavian countries with higher than average labor strength also have higher than average investor protection legislation. *Journal of Comparative Economics* 44 (4) (2016) 854–883. SUNY Buffalo Law School, 618 John Lord O'Brian Hall, Buffalo, NY 14260-1100, United States; SUNY, Department of Economics, University at Buffalo, 423 Fronczak Hall, Buffalo, NY 14260-1100, United States.

© 2016 Association for Comparative Economic Studies. Published by Elsevier Inc. All rights reserved.

1. Introduction

Why do corporate governance law and practice differ across countries? In this paper, we propose a new answer to this question. Our proposal highlights differences in wage-setting structures across countries. The key insight that emerges from our analysis is that there is a nonmonotonic relationship between wage-setting structures and the levels of corporate ownership concentration and investor protection legislation.

The argument runs briefly as follows. The causal thread moves through three steps: from bargaining structures to firm profits, from firm profits to ownership concentration, and then from ownership concentration to investor protection.

First, wage-setting institutions exert a nonmonotonic effect on firms' profits. At low levels of bargaining centralization, unions cannot coordinate their bargaining strategies, which keeps wages relatively low and profits high. At intermediate levels, unions coordinate and adjust wages to extract more rent from firms, which further reduces firms' profits. However, at very high levels of centralization, union coordination and wage compression favor high-productivity firms and penalize low-productivity firms, thereby increasing firms' profits on average.

[☆] Versions of this paper were presented at the 2014 annual meetings of the American Law and Economics Association and the Society for the Advancement of Socio-Economics. We would like to thank Kenneth Kim, Marco Pagano, Mark Roe, Holger Spamann, and two anonymous referees for insightful questions and comments.

* Corresponding author.

E-mail addresses: mdimick@buffalo.edu (M. Dimick), neelrao@buffalo.edu, neelrao@nber.org (N. Rao).

Second, the level of profits influences the degree of ownership concentration. Lower profits make reorganization relatively more attractive to a controlling shareholder, who unlike outside shareholders, is uniquely positioned to capitalize on these opportunities. To do this, a dominant shareholder will increase its ownership stake when profits are lower.

Third, firms' ownership structures influence the level of investor protection. When there are outside investors, a controlling shareholder has an incentive to divert value from the firm for personal gain. Moreover, this incentive is largest for firms with dispersed ownership structures because a controlling shareholder with a relatively small stake bears a smaller share of the costs of diverting shareholder value.¹ Investor protection rules are therefore most valuable to firms with dispersed ownership structures. Consequently, a social planner seeking to maximize the value of the firm will favor stronger investor protection laws when ownership is less concentrated.

Thus, as the centralization of wage-setting institutions rises, ownership concentration at first increases, but then decreases, while investor protections at first decrease, and then increase.

Two groups of explanations dominate the literature on the sources of differences in corporate governance and investor protection across countries. The first—the “legal-origin” hypothesis—suggests that cross-country differences in investor protection can be explained by each country's distinct and historically given legal system (La Porta et al., 1997; 1998; 2000). In particular, the legal-origin authors classify legal systems into four different types: the English-common-law system and the French-, German-, and Scandinavian-civil-law traditions. Their results show that “common-law countries generally have the strongest, and French-civil-law countries the weakest, legal protections of investors, with German- and Scandinavian-civil-law countries located in the middle” (La Porta et al., 1998, 1113).

While our argument is related, importantly, to this cross-country variation identified by the legal-origin authors, the shortcomings of the legal-origin hypothesis are by now well recognized. Among other reasons, there is a lack of a convincing causal mechanism: it is not clear exactly how broad legal traditions actually determine the content of corporate law and the level of investor protections (Pagano and Volpin, 2005a, 1006). Furthermore, the legal-origin argument disappoints as a predictive matter: a country's inherited legal system does not always account for actual change of investor-protective laws in the contemporary world (Pagano and Volpin, 2005a; Roe, 2006). Indeed, there is evidence that at different periods of history, civil-law countries have offered greater protection to investors than common-law countries (Rajan and Zingales, 2003).

The second main explanation for cross-country differences in corporate governance is a story about politics, where the interests of employees feature prominently as an important determinant (Gourevitch and Shinn, 2005; Pagano and Volpin, 2005a; Perotti and von Thadden, 2006; Roe, 2000; 2003). Given the distinctive interests of managers, shareholders, and employees, the political process serves as a crucial mediating factor that transforms these divergent interests into law and policy. Various versions of this theory exist. One argument emphasizes the level of employment protection legislation and its impact on corporate governance and the demand for investor protection (Pagano and Volpin, 2005a). In another account, Perotti and von Thadden (2006) argue that when the median voter has low financial wealth but non-diversified human capital and risky labor rents, he or she will lend political support to low-risk financial institutions (e.g., banks rather than equity markets). More generally, the impact of social democratic politics is seen as injecting the interests of employees at the firm level, in ways that compound already existing conflicts between shareholders and managers (Roe, 2000).²

While agreeing with the emphasis on labor interests, our approach differs from the previous contributions to the politics of corporate governance in several important ways. To put the matter somewhat crudely, other arguments relating employee interests to investor protection are essentially dichotomous or linear: as labor interests become stronger, the level of investor protection or the quality of corporate governance will decrease. However, as we discuss more fully below, while Nordic countries have the highest rates of union membership and the most successful labor parties, they also have relatively high levels of investor protection. In other words, Nordic countries offer better legal protection to investors than some countries with weaker labor movements. This poses a puzzle for the labor politics approach. If strong labor interests are so bad for corporate governance, why is corporate governance so good in Nordic countries?

By good corporate governance, we do not necessarily mean diffuse ownership structures. For example, good corporate governance may prevent a large blockholder from extracting private benefits, making concentrated ownership more attractive to small shareholders. Instead, we define good corporate governance as a high level of protection enjoyed by investors and the relative lack of private benefits of control exerted against minority shareholders. The empirical evidence regarding investor protection and ownership concentration in Nordic countries is discussed further in Section 2. Scandinavian countries exhibit comparatively low ownership concentration and strong investor protection despite a high level of bargaining centralization. This pattern motivates our analysis. We argue that wage-bargaining structure has a nonlinear effect on ownership concentration and investor protection. Our model can thereby account for this puzzle.

In addition, the role of wage-setting structures has been, so far as we are aware, entirely overlooked in corporate governance research. This is somewhat surprising, given the great deal of attention that both the political economy and political science literatures have given to this institutional variable. For both disciplines, the level of wage-bargaining centralization

¹ A further reason that concentrated ownership could reduce the incentive to steal from a firm is organizational damage caused by financial diversion. Because of such behavior, a corporation might suffer from a reputation for mismanagement or the misallocation of personnel. As the controller acquires an increasingly large ownership stake in the firm, it also bears a greater share of this degradation cost, which discourages it from stealing.

² One concrete manifestation of employee voice analyzed by Roe and others is codetermination, which is the inclusion of labor representatives on the (supervisory) board of directors (Pistor, 1999; Roe, 2000).

Download English Version:

<https://daneshyari.com/en/article/5092144>

Download Persian Version:

<https://daneshyari.com/article/5092144>

[Daneshyari.com](https://daneshyari.com)