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Trust and the regulation of corporate self-dealing

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ABSTRACT

The economic impact of corporate self-dealing and the regulation against such activity both vary across countries. In this work, we examine the influence of trust on shareholder protection. We hypothesize that anonymous trust can affect self-dealing through two channels. First, trust may complement existing formal regulation. Alternatively, trust and formal regulation can act as substitutes. To test these hypotheses, we examine the association between a country's anti-self-dealing index and anonymous trust. We find that anonymous trust inversely relates to formal self-dealing regulation. We further find that anonymous trust positively relates to financial market development. Collectively, this evidence suggests that trust substitutes for formal self-dealing regulation, providing an alternative mechanism for shareholder protection.

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1. Introduction

When shareholders supply capital to the firm, they delegate to managers the day-to-day responsibility for use of those resources. Managers, however, at their own discretion may deploy these funds to benefit themselves at the expense of shareholders. This self-dealing undermines shareholder confidence in financial markets and results in an inefficient transfer of capital and stymied economic development.[1]

Recent studies emphasize that differences in formal investor protection across countries impact the ability of managers to expropriate shareholder wealth (e.g., Shleifer and Vishny, 1997; La Porta et al., 1997a; Shleifer and Wolfenzon, 2002). La Porta et al. (1998) along with Djankov et al. (2008) explain this variation in investor protection by examining formal rules and regulations designed to limit self-dealing.[2] Djankov et al. (2008) further show that a country's legal origin determines the adoption of such rules. Largely unexplored, however, is how informal norms may also influence investor protection.

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[1] Jensen and Meckling (1976) refer to this economic loss generally as the "residual loss" resulting from gains from trade neglected, due to the agent's lack of proper incentives.

[2] In addition to country-level regulation, firms often adopt corporate governance policies through the organization of boards and incentive-based compensation. Not surprisingly, by aligning the interests of managers with shareholders, these practices are linked to better performance (La Porta et al., 2002; Klapper and Love, 2004; Durnev and Kim, 2005).

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In this paper, we examine how anonymous trust influences shareholder protection against self-dealing of corporate insiders. We focus on anonymous trust because of its ability to promote cooperative attitudes outside of local networks, which is the type of cooperation needed to facilitate financial exchange.

A financial exchange places resources at the disposal of another party with the expectation of a beneficial economic payoff. This type of transaction seldom involves face-to-face interaction and is often impersonal in nature. Thus, shareholders supply capital only when they expect managers not to cheat and expropriate wealth. In this context, trust facilitates the supply of capital because shareholders believe managers will act in their best interest. Guiso et al. (2008) find support for this argument, documenting that trusting individuals invest more in the stock market. More broadly, a large body of empirical work finds evidence suggesting that trusting societies experience higher levels of economic and financial development (e.g., Knack and Keefer, 1997; Zak and Knack, 2001; Guiso et al., 2004; Tabellini, 2010; Algan and Cahuc, 2010).

Our paper provides a specific mechanism for how trust relates to financial outcomes—by influencing shareholder protection. We hypothesize two channels through which trust may influence this protection. First, countries can adopt formal legal provisions to protect shareholders and promote financial development. However, Algan and Cahuc (2013) argue that it is difficult, if not impossible, to create formal rules that sustain all complex financial exchanges—similar to the difficulty of writing complete contracts. Trust may fill these missing gaps, lowering transaction and monitoring costs, thereby complementing formal self-dealing regulation. The combined outcome is less self-dealing behavior and greater financial development.

Second, trust and formal regulation may act as substitutes. On one hand, trust can substitute for formal regulation. In the presence of weak formal rules protecting shareholders, trust is critical for facilitating financial exchange (Knack and Keefer, 1997). In trusting societies, individuals do not expect to be cheated because they believe others have internalized moral rules deterring self-dealing behavior. Thus, individuals may not demand formal regulation to prevent self-dealing. In these societies, trust can substitute for formal regulation, directly providing shareholder protection.

On the other hand, formal self-dealing regulation may substitute for a lack of trust. Individuals in low trust societies expect others to behave opportunistically. They therefore demand government regulation to promote cooperation and exchange (Aghion et al., 2010). In this scenario, anti-self-dealing regulation substitutes for a lack of trust and provides shareholder protection.

To test these conjectures, we empirically examine the association between a measure of anonymous trust and the country-level anti-self-dealing (ASD) index. This index, developed by Djankov et al. (2008), measures formal legal rules of minority shareholder protection against expropriation by corporate insiders. Anonymous trust, collected from the World Values Surveys (WVS), captures how trustworthy an individual perceives those whom they meet for the first time.

Our evidence suggests that anonymous trust is inversely associated with formal self-dealing regulation. A one standard deviation increase in anonymous trust reduces the ASD index by approximately a one-half standard deviation. This result is robust when controlling for endogeneity, institutional quality, and economic factors. The inverse association suggests that anonymous trust and formal regulation act as substitutes.

We further find that anonymous trust positively relates to financial market development. Specifically, anonymous trust is positively associated with market capitalization, number of firms per capita, IPOs to GDP, share turnover, and GDP per capita, and is negatively associated with the benefits of private control. Thus, while anonymous trust negatively impacts formal shareholder protection on the books, we find that it positively relates to measures of a healthy financial system. This finding lends support to the hypothesis that anonymous trust can substitute for formal shareholder protection, limiting self-dealing behavior and promoting financial development.

Our paper contributes to the literature at the intersection of culture and finance. Griffin et al. (2014) find that culture influences corporate governance across countries. We find that trust affects country level rules pertaining to investor protection. Our work also closely relates to Licht et al. (2005) who find cultures that minimize uncertainty and promote social harmony have less formal shareholder protection. Djankov et al. (2008) show that legal origins predict the ASD index. For all measures of shareholder protection, they find a pronounced difference between common and civil law countries. They note that, "this does not mean that politics, media, or culture do not affect legal rules – they surely do" (p. 462). Our findings suggest that anonymous trust is one such predictor.

Perhaps the greatest distinction between our work and previous literature is that we empirically link anonymous trust *inversely* to formal shareholder protection, yet anonymous trust *positively* predicts financial development. We view this combined result as suggesting that trust can substitute for formal regulation, providing an alternative mechanism for shareholder protection.

2. Conceptual framework

2.1. Trust and finance literature

Trust exists when an individual places resources at the disposal of another party without a legal commitment but with an expectation that this act will have a beneficial economic payoff (Coleman, 1990). Due to the promise of future payment with an often-unknown party, financial transactions face larger transaction costs than other forms of exchange. Trust can lower these costs. La Porta et al. (1997b) argue trust is important for generating cooperation among people who interact infrequently. This applies to minority shareholders since they are unlikely to know controlling shareholders or top managers personally.

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