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The bright side of labor protection in emerging markets: The case of firm transparency

Xiaoran Ni[a,*], Weikang Zhu[b]

[a] Department of Finance, School of Economics & Wang Yanan Institute for Studies in Economics (WISE), Xiamen University, China
[b] PBC School of Finance, Tsinghua University, China

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ABSTRACT

Using a unique regulatory change (the enactment of the Labor Contract Law) in China, we find that the strengthening of labor protection leads to a significant increase in firm transparency. Further analyses indicate that stronger labor protection reduces operating flexibility, which can exert external pressure on firms and exacerbate managerial short-termism problems. To counteract the unfavorable challenge, shareholders re-contract with managers by granting more equity incentives and less perks. This improved compensation structure relieves managers from short-term concerns and incentivizes them to disclose more firm-specific information. Our findings provide new insights on the bright side of labor protection and shed light on how stringent laws can shape the information environment in emerging markets.

1. Introduction

There has been a heated debate over the economic impact of labor protection. Although academics have paid much attention to whether labor protection can affect firm operation and economic growth (e.g., Acharya et al., 2014; Simintzi et al., 2015; Serfling, 2016), the impact of labor protection (or in a broader sense, stringent operating environment) on firm transparency has not received much attention. Given the important role of the information flow between firms and investors in external monitoring and curtailing agency problems, this paper attempts to fill this gap. We find that stronger labor protection is associated with a significant improvement in firm transparency.

Theoretically, labor protection can affect firm transparency in either direction. Stronger labor protection increases the rigidity of firms' cost structures, which can reduce operating flexibility, raise operating leverage and increase distress risk (Simintzi et al., 2015; Serfling, 2016). Increased external pressure can exacerbate managerial short-termism problems by inducing managers to conceal poor performances and provide more opaque information (Armstrong et al., 2012; Chen et al., 2015) as well as cut value-enhancing risky projects (Stein, 1988; John et al., 2008). In this scenario, shareholders can re-contract with their managers to mitigate the adverse effects and encourage risk-taking (Holmstrom and Milgrom, 1987; De Angelis et al., 2017). If these adjustments can mitigate agency problems and provide incentives to focus on long-term goals, managers may choose to report firm performances truthfully, resulting in improved firm transparency.

However, to offset increased exposure to operating risks, managers may require a compensation premium (Aggarwal and Samwick, 1999), or to extract more private benefits at the expense of shareholders (Bebchuk and Fried, 2003). Entrenched managers are likely to withhold or even manipulate information disclosed to outside investors to conceal their attempts to expropriate wealth (Aboody and Lev, 2000; Aboody and Kasznik, 2000; Bartov and Mohanram, 2004). Additionally, even though the improved compensation (e.g., increased equity incentives) can effectively encourage risk-taking, it may also boost misreporting (Efendi et al., 2007; Armstrong et al., 2013) and result in a less transparent information environment.

* Corresponding author at: N112, Economics Bldg, Xiamen University, 361005, China
E-mail address: nxr.08@sem.tsinghua.edu.cn (X. Ni).

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We seek to distinguish these two opposite conjectures. However, because of the endogenous nature of labor protection, identifying the causal relation between labor protection and firm transparency is empirically challenging. To address this issue, we employ a jurisdictional change in China, the enactment of Labor Contract Law (LCL) in 2008, as an exogenous shock to the intensity of firm labor protection. We find that following the enactment of LCL, firm transparency improves significantly. Further analyses indicate that this positive relation holds because changed compensation structure alleviates managerial short-termism problems and encourages managers to disclose more firm-specific information.

We present comprehensive evidence to support our argument. To begin with, we examine the reduced-form relation between labor protection and stock price informativeness. We use the stock price informativeness measure of Durnev et al. (2003), defined as firm-specific stock return variation, as the primary proxy for firm transparency. We find strong evidence that following the enactment of LCL, stock price informativeness increases significantly.

To address the concern that the parallel-trend assumption of the difference-in-difference setting can be violated because of ex ante differences in firms with different levels of labor intensity, we conduct a dynamic test around the time of the enactment of the law. We find that the pre-existing trends in stock price informativeness do not exist. Another potential concern is that the passage of LCL may be correlated with other events surrounding the time the LCL was adopted. We rule this out by re-estimating the effects using a series of year indicator variables for pre- and post-regulation periods and find that those pre-regulation pseudo-event years cannot explain our main findings. Additionally, the main effect concentrates in non-export firms rather than export firms, and the effect of the financial crisis is unlikely to bring about such patterns. In addition, we find that the effect is more pronounced when the firm is located in regions with higher efficiency of law enforcement, indicating that our main findings should be attributable to legislative change rather than financial crisis shocks.

However, our main results could be merely interpreted to mean that strengthened labor protection increases firm-specific risk. To alleviate such concerns, we introduce several supplementary proxies for firm transparency, namely, illiquidity, stock turnover rate, disclosure quality, dedicated institutional ownership, and stock price synchronicity. We find that after the enactment of LCL, stock liquidity, turnover rate, disclosure quality, and dedicated institutional ownership increase and that stock price synchronicity drops. These findings indicate that the enactment of LCL leads to a significant increase in overall firm transparency. We also conduct several other robustness checks, and these results confirm our causal interpretation.

In the next section, we investigate possible mechanisms underlying the causal relation between labor protection and firm transparency. Stronger labor protection makes it harder to adjust labor costs, which raises operating leverage and increases distress risks (Kahl et al., 2014; Serfling, 2016). We find that the enactment of LCL leads to a significant decrease in operating flexibility, which likely increases operating risks. Previous literature argues that managerial short-termism can be alleviated by granting stock-based compensation to managers or by enhancing monitoring (Bushee, 1998; Cheng, 2004). Indeed, we find that as increased external pressures may exacerbate managerial short-termism problems, shareholders are more likely to compensate managers with equity incentives to reduce their exposure to adverse effects and encourage risk-taking. Also, managerial perks decrease, implying that shareholders manage to increase scrutiny and mitigate agency problems. Furthermore, we find that changed compensation structure encourages innovation, reduces managers' incentives to manipulate earnings, and encourages them to disclose bad news in a timely fashion. These findings indicate that managers have fewer short-term concerns and pursue more long-term goals.

Lastly, we explore the economic implications of LCL. In accordance with the improvement in firm transparency, we find that operating efficiency, firm performance and market value improve significantly after law enforcement, implying a better alignment of manager-shareholder interests.

In summary, this paper suggests that firm transparency improves following the enactment of LCL. Our findings show that increased labor adjustment costs reduce operating flexibility and increase operating risk and that shareholders change the structure of managerial compensation to alleviate potential short-termism problems. Once the managers are insulated from short-term pressures, they put more efforts into long-run value creation and become less concerned about concealing firm-specific information.

The rest of this paper proceeds as follows: Section 2 introduces the institutional background of labor protection in China and hypothesis development of our main arguments. Section 3 outlines the data and the empirical design used in this paper. Section 4 presents our main results. Section 5 discusses possible mechanisms underlying our findings. Section 6 provides concluding remarks.

2. Background and hypothesis development

2.1. Institutional background

China is a suitable experimental ground on this topic for at least two reasons. First, China has long been recognized as a country with under-developed legal and financial systems (Allen et al., 2005) and an opaque capital market with little firm-specific information produced (Morck et al., 2000). Its poorly regulated labor market has provided cheap labor to fuel the economy and maintain a high economic growth rate. However, the 2007 Chinese slave scandal, together with a series of serious coal mining accidents from poor safety conditions, pressured the government to put forward stronger labor protection, especially for rural migrant workers with dangerous working conditions and little income security.[1] On June 29, 2007, the LCL was adopted by the Standing Committee of the Chinese National People's Congress and came into effect on January 1, 2008. This law is more strictly and

[1] https://en.wikipedia.org/wiki/2007_Chinese_slave_scandal. It was a series of forced labor cases in Shanxi, China. Thousands of Chinese people including many children had been forced to work as slaves in illegal brickyards and were tortured by the owners of the brickyards. As of June 2007, approximately 550 people have been rescued from such situations.