Corporate Governance and Interest Group Politics

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Main Points

- Paper develops a political economy/interest groups analysis of investor protection.
- Identifies a wide range of circumstances under which the lobbying game produces a sub-optimal level of investor protection.
- Factors that distort outcomes in favor of insiders:
  - Insiders' ability to use the resources of the public company under their control for lobbying activities;
  - Institutional investors' inability to capture the full benefits to outside investors from improved protection.
- Agency problems operate also at level of the lobbying that produces the arrangements governing agency problems
- The presence of new firms going public, and entrepreneurs seeking to attract capital in the future, can diminish the distortions in favor of corporate insiders – but does not eliminate them.
- Analysis generates a wide range of testable predictions concerning differences in investor protection over time and around the world.

Politics and Investor Protection

There is now widespread recognition that the level of Investor protection affects the size and value of public equity markets.

But:

- What determines the level of investor protection offered by corporate law rules?
- Why do many countries persist in offering what seems like insufficient investor protection?

What Factors May Lead to Insufficient Levels of Investor Protection?

- Insufficient understanding?
- Or political impediments?

To explore the possibility of political impediments, we develop a political economy model of how the level of investor protection is set.

[“Developing formal models [of the political economy of corporate governance] “is a fascinating uncharted territory for creative theorists.” Morck, Wolfenzon, and Yeung, *Journal of Economic Literature* (2005).]

Framework of Analysis

Two Central Premises:

- Investor protection provided by public officials matters:
In the absence of the necessary rules and legal and institutional infrastructure, firms cannot provide optimal investor protection by adopting appropriate arrangements in their charters.

- Politicians can change investor protection choices from time to time:
Investor protection is not set once and for all, before the creation of a country's public equity markets. Choices need to be made from time to time
  - ⤷ We focus on choices that are made in economies that already have public equity markets.

The Economy

Consider a representative period in an economy with public equity market and institutional investors.

The sequence of events:

- In the beginning of the period, the economy has *N* public firms.
- Three interest groups compete:
  - Insiders in existing public firms
  - Entrepreneurs planning to take new firms public
  - Institutional investors
- The politician sets investor protection.
- Entrepreneurs take *M* firms public.
- Payoffs in the *N*+*M* public firms are realized and distributed.

Firms, Insiders, and Outsiders

Each publicly held firm has an “insider” that controls decision-making.

- Insider holds a fraction α of shares and outside investors hold the rest.
- Individuals in the economy invest in shares both directly and indirectly through institutional investors -- mutual funds, pension funds, other asset managers, banks.
- A fraction β of outsiders’ shares is held by institutional investors whose arrangements with their own beneficial investors give them a fraction μ of the profits made by these beneficial investors.

Investor Protection

- Corporate law rules affect b, the size of insiders' private benefits of control.
- Increasing private benefits (beyond a certain point) reduces shareholders' cash flows c.
- It is efficient to set private benefits at a level $b^* > 0$ defined by $c'(b^*) = 1$.
- All of this is known the politician.
- Will the politician set $b = b^*$?

Payoffs

For any choice of b that exceeds b^*, for each of the existing N public companies:

- Corporate insiders of existing companies gain:

$$b - \alpha\ c(b)$$

- Outside shareholders lose

$$(1 - \alpha)\ c(b)$$

with institutional investors losing

$$\mu\ \beta\ (1 - \alpha)\ c(b)$$

For each of the M new firms:

- Entrepreneurs planning to go public lose: $b - c(b)$

The Politician

Maximizes an objective function that is a weighted average of social welfare and contributions from interest groups:

$$w_1(b - c(b)) + w_2 p$$

where:

- p denotes the total sum of contributions that interest groups make to the politician.
- w_1 and w_2 are weights assigned to social welfare and contributions in the politician's objective function.

Interest Groups

There are three organized interest groups:

- Corporate insiders
- Institutional investors
- Entrepreneurs

Individual investors are too “small” and dispersed to engage in effective lobbying.

Using Public Firms' Resources for Lobbying

- Insiders may use the firm's resources to finance their influence expenditures.

  [Because influence activities can also benefit shareholders, prohibiting them is not in the interest of shareholders.]

- Institutional investors cannot use the resources of the publicly traded firms.

The Interest Groups Game

- Insiders, institutional investors, and entrepreneurs offer the politician contribution schedules specifying what benefits they will provide for any given choice of the level of private benefits b.
- Politician chooses investor protection given the contribution schedules.

We seek to identify the equilibrium.

Political Equilibrium in the Special Case where No New Capital is Raised

Proposition 1. Assume an economy in which no new capital is raised from outside investors, and in which at least one of the following conditions holds:

(I) Insiders can use existing firms' resources for influence activities;

(II) Some individual investors hold shares directly in public firms; or

(III) Institutional investors pass on to their investors some of the benefits of improved protection.

Then the lobbying game has a unique equilibrium in which:

- Investor protection is sub-optimal,
- Private benefits are excessive.

Intuition for Proposition 1

- Lobbying game would produce an efficient outcome in the hypothetical case in which both the pro-insider and pro-outsider lobby fully bear costs of lobbying and capture fully the benefits to their side of lobbying.
- However, in the actual lobbying game:
  - Insiders are willing to spend more to obtain a given increase in private benefits of control than the value to them of the increase.
  - Institutional investors are willing to spend less to prevent a given increase in private benefits than the resulting cost for outside investors.
- Insiders, institutional investors, and the politician don't fully internalize the negative externality that increasing private benefits imposes on outside investors.

Political Equilibrium in the General Case where Entrepreneurs Raise New Capital

Proposition 2. Consider an economy in which new capital is expected to be raised by entrepreneurs and in which at least one of the following conditions holds:

(i) Insiders can use existing firms' resources to finance influence activities;

(ii) Some individual investors hold shares directly in public firms; or

(iii) Institutional investors have to pass on to their investors some of the benefits of improved investor protection.

Then in the unique equilibrium:

- Investor protection is sub-optimal and private benefits are excessive,
- but to a lesser extent than in the case new capital is not raised from outside investors.

Intuition for Proposition 2

- The addition of entrepreneurs to the lobbying game moderates distortion in favor of excessive private benefits because the entrepreneurs lose from increasing private benefits beyond b^*.
- However, the combined interests of the participants in the lobbying game still do not fully internalize the negative externality that lax protection imposes on outside investors in existing companies.

New Capital Raising by Existing Public Firms

- Suppose that the new *M* public firms will be created not by entrepreneurs as publicly held subsidiaries of existing public companies.

Proposition 3. If the new firms for which capital will be raised will be subsidiaries of existing public firms, investor protection will be weaker, and private benefits will be higher, than in the case in which new firms will be established solely by entrepreneurs not affiliated with existing public firms.

Publicly Traded Institutional Investors

Proposition 4. If the institutional investors are themselves publicly traded firms with outside investors, then the level of investor protection will become more lax and private benefits of control will be more excessive than in the case in which institutional investors are closely held.

Durability of Investor Protection Choices

Proposition 5. If the politician sets investor protection levels less often, the distortion in the level of investor protection and the level of private benefits of control will become less severe.

Voting and the Role of the Media

Suppose that the politician's choice of investor protection level has a meaningful direct effect on voting.

Proposition 6. If investor protection decisions have a direct effect on voting decisions, then the lobbying game will have a unique equilibrium with stronger investor protection and lower private benefits of control than in the case in which no such direct effect exists.

Predictions (1)

Investor protection and the susceptibility of officials decisions to lobbying:

Prediction 1: Investor protection will be lower when public officials setting the level of investor protection attach a relatively high weight to interest group contributions in their objective function.

Prediction 2: Investor protection will be lower when interest groups seeking to influence politicians face weaker constraints on their influence activities and thus have a less expensive “influence technology.”

Predictions (2)

Investor protection and the horizon of players:

Prediction 3: Investor protection will be higher when the legal and institutional structures make investor protection choices more lasting and difficult to reverse.

Predictions (3)

Investor protection and the stage of the economy:

Prediction 4: Investor protection will be higher in growing economies that have a relatively large need for raising additional equity capital from outside equity investors.

Prediction 5: Investor protection will be higher when the fraction of the electorate that directly or indirectly owns shares in public companies is large.

Predictions (4)

Investor protection and corporate structures and activities:

Prediction 6: Among economies with controlling shareholders, investor protection will be lower in those in which controllers hold low fraction of cash flows rights due to separation of cash flow rights and voting rights.

Prediction 7: Investor protection will be lower when the economy is dominated by conglomerates, with new publicly traded companies tending to be created as subsidiaries or affiliates of existing public companies rather than as stand-alone entities.

Predictions (5)

Investor protection and public perceptions:

Prediction 8: Investor protection will be higher when the media is more active and/or when individuals are more financially educated.

Prediction 9: Investor protection will be higher following scandals or crashes that make problems of insider opportunism more salient.

Conclusions

- Under a wide set of circumstances, interest group politics will produce investor protection that is too lax.
- The interests of entrepreneurs and existing public firms in raising more equity capital in a growing economy moderates but does not eliminate these distortions.
- The identified forces can contribute to understanding the patterns of investor protection levels around the world and over time.