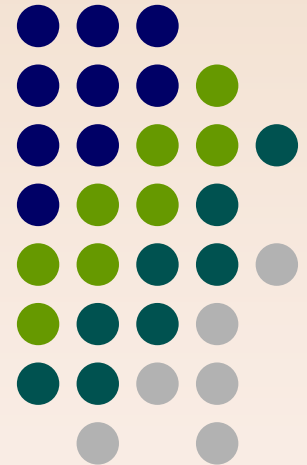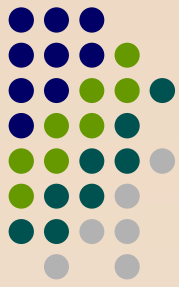# Corporate Governance and Interest Group Politics

Lucian Bebchuk

Harvard University

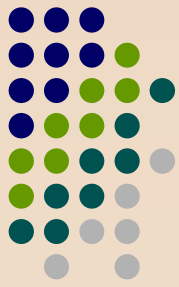Zvika Neeman

Boston University

Tel-Aviv University

Main Points

- Paper develops a political economy model of the lobbying game over investor protection levels.

- Identifies a wide range of circumstances under which the lobbying game does not have an equilibrium with an efficient level of investor protection.

- Factors that work 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.

- The presence of new firms going public, and entrepreneurs seeking to attract capital in the future, can diminish -- but does not eliminate distortions -- in favor of corporate insiders.

- Model generates a wide range of testable predictions concerning how investor protection can be expected to vary over time and around the world.
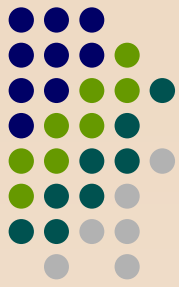
Politics and Investor Protection

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?

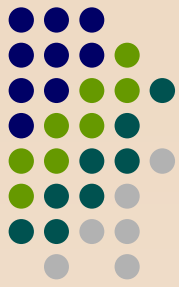# Question: what is insufficient investors' protection due to?

- Insufficient understanding?
- Or political impediments?

To explore the possibility of political impediments, we develop a formal 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."
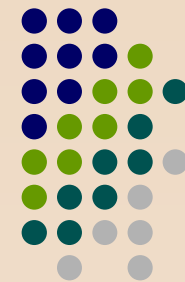
Morck, Wolfenzon, and Yeung, *Journal of Economic Literature* (2005).

Models of the Politics of Investor Protection

- Voting models: Pagano and Volpin (2005a, 2005b), Perrotti and Von:-Thadden (2004):

  In contrast, we focus on lobbying

- Perrotti and Volpin (2005): Interest group model of incumbent firms' effort to weaken investor protection to discourage entry by new firms (Rajan and Zingales (2003)).

  In contrast, we put aside this consideration (assuming that entry by new firms does not reduce the profits of existing firms) -- focus on the interests of insiders in extracting rents from the capital public firms already have.
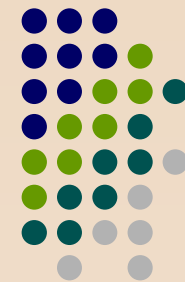
Framework of Analysis

We assume that:

- <u>Investor protection provided by public officials matters</u>: 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.

- <u>Politicians can change investor protection choices from time to time</u>: 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.
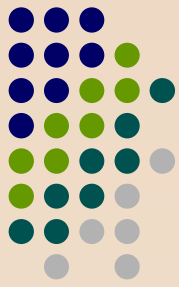
The Economy

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.

  [Abstract from distortions arising from entry-deterrence motivations (Rajan-Zingales (2003), Morck, Wolfeonzon, Yeung (2005), Perrotti – Volpin (2005)]

- Payoffs in the $N+M$ public firms are realized and distributed.
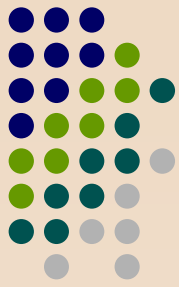
Firms, Insiders, and Outsiders

In the considered period:

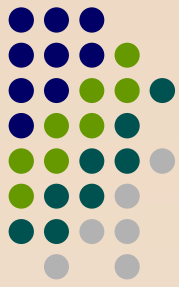Each publicly held firm has an "insider" that controls decision-making.

- Insider holds a fraction α of shares.

- Outside investors' fraction is 1- α .

- Agents in the economy hold diversified portfolios, either directly or indirectly through institutional investors (mutual funds, pension funds, other asset managers, banks).

- We assume that, in each company, a fraction β of outsiders' shares is held by institutional investors that are compensated by a linear contract:

  const. + $\mu \times$ (cash flow generated by firm)

Investor Protection

- Denote the laxity of corporate law rules by $\lambda \geq 0$.

- The laxity of corporate law rules affects the size of the private benefits of control, denoted $b(\lambda)$. $b(\lambda)$ is increasing in λ.

- Cash flows to shareholders decline by $c(b)$, where c' > 0, c'' > 0.

- We assume that $c'(0) < 1$, which implies that it is efficient to set $b = b^* > 0$ that is defined by the equation
$$c'(b^*) = 1$$

- The politician determines λ and therefore indirectly b -- The question is: 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
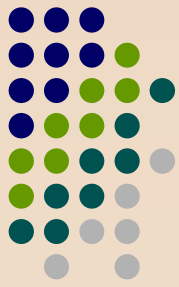$$(1 - \alpha) \, c(b)$$
with institutional investors
$$\mu \, \beta \, (1 - \alpha) \, c(b)$$
of this amount.

For each of the M new firms:

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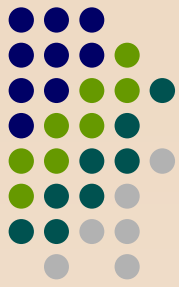
The Politician

Maximizes the following objective function:

$$u_P(b,p) = w_1(b - c(b)) + w_2 p$$

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.
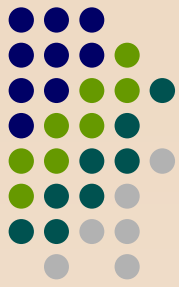
Interest Groups

There are three organized interest groups:
- Corporate insiders
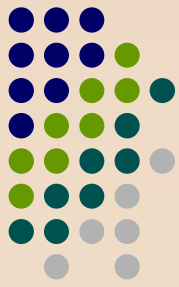- Institutional investors
- Entrepreneurs

Individual investors are too "small" and dispersed to engage in effective lobbying.
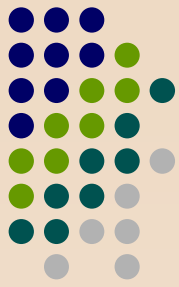
Using Public Firms' Resources for Lobbying

- 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

- The influence technology: We assume that every dollar of benefits enjoyed by the politician costs $K to the organized interest group providing it.

- Insiders, institutional investors, and entrepreneurs offer the politician contribution schedules $C_I(b)$, $C_M(b)$, $C_E(b) \geq 0$.
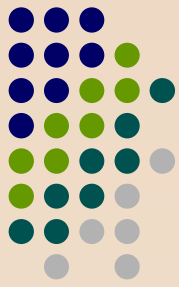
Equilibrium

- Politician optimizes given contribution schedules.
- Contribution schedules for the lobbies are such that none of them wants to change its own contribution schedule given the others' contribution schedules and the politician's anticipated choice.

[Following the literature, we focus on truthful Nash Equilibria.]

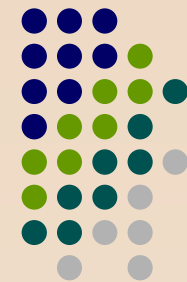# Political Equilibrium in the Special Case where No New Capital is Raised

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 in the unique truthful Nash equilibrium:

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

Intuition for Proposition 1

- At the optimal level of investor protection, the marginal benefit to insiders of increasing b is equal to the outsiders' marginal cost.

- However, in the lobbying game:

  - Insiders are willing to spend more to obtain a given increase in b than the benefit to them from the increase.

  - Institutional investors are willing to spend less to prevent a given increase in b than the resulting increase in c for outside investors.

- Insiders, institutional investors, and the politician don't fully internalize the negative externality that increasing b imposes on outside investors.

Political Equilibrium in the General Case where Entrepreneurs Raise New Capital
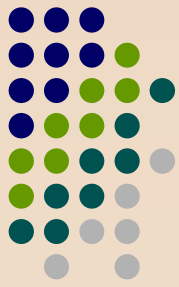
Proposition 2. Assume an economy in which new capital is expected to be raised by entrepreneurs and in which at least one of the following conditions holds:

(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.

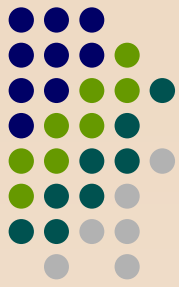Then in the unique truthful Nash equilibrium:

- 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 high b because the entrepreneurs lose from increasing b 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.
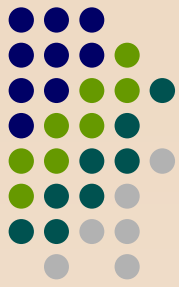
New Capital Raising by Existing Public Firms

- Suppose that the new *M* public firms will be created not by entrepreneurs as publicly held subsidiaries of existing public companies.
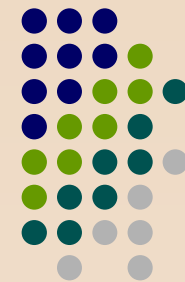
Proposition 3. If the new firms for which capital will be raised will be subsidiaries of existing public firms, investor protection will be weaker, and private benefits will be higher, than in the case in which new firms will be established by entrepreneurs not affiliated with existing public firms.

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 be
more lax and private benefits of control will be more
excessive, in comparison to the equilibria described in
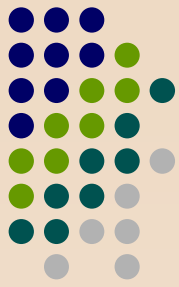propositions 1-3.

Durability of Investor Protection Choices

Proposition 5. In the economies described in Propositions 1-3, if the politician sets investor protection levels less often than in the beginning of each other period, then in the unique truthful Nash equilibrium:

- The distortion in the level of investor protection and the level of private benefits of control will be less severe in comparison to the equilibria described in Propositions 1-3.
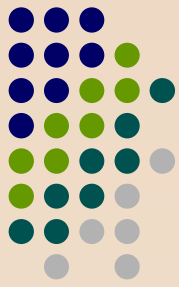
Voting and the Role of the Media (1)

Suppose that the politician's choice of investor protection level has a meaningful direct effect on voting. Specifically, assume the politician's objective is to maximize:

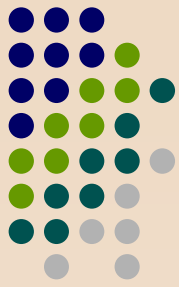$u_P(b,p) = w_1(b - c(b)) + w_2 p - w_3\, v(\theta,b,s)$

where:

- p denotes the total sum of contributions to the politician,

- $v(\theta,b,s)$ denotes the number of votes to be lost as a function of b, the fraction of the population that invests in public companies θ, and the salience of corporate governance issues s; and

- w_1, w_2, $w_3 > 0$ are weights.

Voting and the Role of the Media (2)

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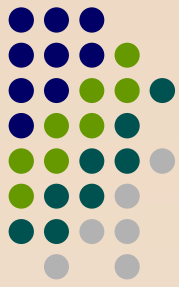than in the case in which no such direct effect exists.

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."
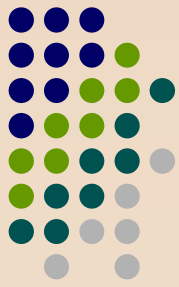
Predictions (2)

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.
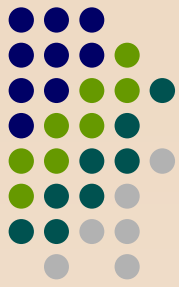
Predictions (3)

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.
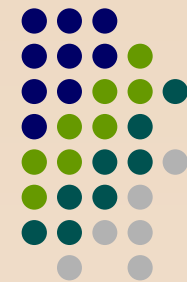
Predictions (4)

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.
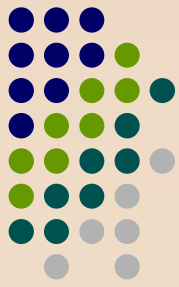
Predictions (5)

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, the interest group game in economies with public firms tends to 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 variance of investor protection levels around the world and over time.