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Is Corporate Governance a First Order Cause of the Current Malaise?

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The United States, indeed much of the OECD, seems caught in a certain malaise. Take three salient problems, the “triad”: significant inequality; economic insecurity; and slow economic growth. In the search for causes and remedies, some have identified the governance of large public corporations, “corporate governance,” as a first order cause. To some extent I think there are important corporate governance elements in each of these problems, potentially remediable. Even with significant corporate governance changes, however, the pressures from globalizing product and capital markets will produce an on-going need for complementary government policies to mitigate adjustment costs that no firm can internalize over the long run.

This will sketch out some of the arguments.

Income Inequality

Corporate governance affects income inequality on at least three vectors: executive compensation; gains received by partners and limited partners of private equity firms; and the declining share of enterprise profits that goes to employees, the “labor share.”

(i) Executive compensation. Corporate governance has played a significant role in (i) the shift to stock-based compensation and (ii) “golden parachute” severance agreements that produce very large payouts for target managements when triggered in merger transactions. The turn to stock-based pay in the US in the 1990s was the result of the limitations in the monitoring capacity of diffuse shareholders operating through a board model dependent upon “thinly informed” directors that relied principally on stock prices for their monitoring. Gordon (2007), Gordon (2015). The turn to golden parachute agreements, which included accelerated vesting of stock options in the event of a merger, was in response to judicial sanctioning of “just say no” defensive measures by a target board. In effect the Delaware courts gave the management team a takeover resistance endowment that shareholders could buy back through golden parachute payments. The favorable accounting treatment that stock options initially received (no immediate expensing) led to quite large option grants.

Because of the size and importance of US firms, the US compensation pattern became the “market” throughout much of the OECD. Even though US corporate governance has significantly improved (active board monitoring, the reconcentration of ownership in the US (Gilson & Gordon (2013)), and the say-on-pay mandate of the Dodd Frank Act of 2010 provides a potentially corrective channel, the path dependency of compensation structure and levels have been a formidable barrier to change.

(ii) PE Compensation. Piketty sees rising executive compensation as a major source of inequality. In the US this is partly right but mostly wrong. It is mostly wrong because the evidence is the disproportionate share of the income gains in the US are going not to the top 1% but rather the top 0.1%. This group is receiving income not through “executive compensation,” but through flow-through vehicles reflective of the partnership and limited partnership arrangements that characterize private equity funds.

In turn, this PE compensation is partly rooted in the corporate governance shortfalls of the public company model in the US. As argued in Gilson & Gordon (2017), the “take private” transactions of PE

firms partly result from the monitoring limitations of the present thinly-informed/under-resourced model of independent directors. Such a board is (1) beholden to stock market valuations, which may not reflect the value of particular strategies that cannot for competitive reasons be adequately disclosed, and (2) cannot convincingly rebut the claims of activists who assert strategic and operational shortfalls. By contrast, the PE governance model can provide much deeper monitoring capacity and thus create additional value both through strategic enablement and superior operations. A better board model for public companies, "Board 3.0," which includes well-resourced, well-informed and well-compensated directors, would open up a new option for public companies and permit a broader sharing of gains from superior performance, the financial inclusion of public shareholders.

(iii) The "Labor Share." The "labor share" of enterprise rents has been declining for more than 25 years in the United States. Over the period corporations have been run with decreasing levels of what might be called "slack" – the different between current operations and a set that will maximize shareholder returns and shareholder value. The role of hostile bids and shareholder activism in this process is first order, mostly because of the governance externalities of such interventions as they proliferate. It used to be the case that US corporations could run with 50% or more slack. These are the margins that evoked hostile bids, in which bidders could offer high premium even without detailed inside knowledge of a company's business. The era of hostile bids ended in the 1990s less because of Delaware's takeover jurisprudence and more because many management teams undertook measures to eliminate the slack that might make them a potential target. A similar process is underway in the wake of shareholder activism. Firms that formerly ran with 20% slack, for example, are now vulnerable to activists who are prepared to intervene to obtain returns of 10%.

A consequence of these pressures to reduce slack has been the increasingly routine layoff of employees whose net marginal labor productivity is not positive or even their continued employment no longer fits the current strategy. In the 1970s, for a profitable firm to lay-off employees was quite rare. In the current environment, well-managed large firms seem continuously engaged in partial downsizing. Yet for employees, finding a new job is costly, and for a meaningful fraction of employees, wage loss after re-employment will be significant. The threat of these negative effects have been an important element in restraining wage growth below the level of profit growth, particularly in the case of firms that face competitive pressure from global competitors.

Economic Insecurity

Corporate governance has played an important role in increasing the adjustment costs of economic change. The liberalization of product markets and capital markets means that firms must operate in an increasingly competitive environment. Corporate governance is the mechanism by which these competitive market pressures bear down on managerial decision-making. As noted previously in the discussions of the "labor share," the consequence will be greater insecurity for many employees. High-powered corporate governance is likely to heighten these insecurities because the level of competitive pressure is not fixed. Efficiency-focused shareholders may push firms to respond quickly to a changed competitive environment, unheeding of adjustment cost issues (to the extent not required by law). A rapid response by one firm in a competitive environment will evoke rapid responses from its competitors, leading to a change in the rate of economic change, an increase in the second derivative, which will much increase the realization rate of adjustment costs.

Slow Economic Growth

Some have asserted that the slow growth rate is at least partially the result of under-investment by public corporations which in turn the consequence of "short-termism," reflected in stock buy-backs and cutbacks in R&D by firms that are responding to activist shareholder concerns. A recent SEC analysis of

US data that examines capital formation over the past decade points to ample available funding for projects. Work on the slowing pace of innovation (R. Gordon 2016) and adverse demographic changes suggest that deeper factors are at work in the slow rate of growth. The long term/short term debate lacks a certain theoretical coherence, given that the "right term" for investment differs by industry sector: "long term" for Apple and for an electricity generating utility are hugely different. Moreover, "right term" for a private firm needs to take account of a macro-economic environment in which actions by governments and central banks can significantly change the level of aggregate demand and vary financial stability. Those calling for greater "investment" by private firms seem to be using the short term/long term cudgel to produce a private sector stimulus program to address a shortfall in fiscal policy making.

Solutions Within Corporate Governance

The increasing predominance of institutional owners in the United States (now roughly 75% owners of most public companies) and the increasing diversification of such owners raise the possibility of a significant shift in the institutional owners' objective function. Such owners will directly face non-diversifiable risk. The build-up of socio-political pressure from the triad gives rise to a systemic risk that will affect asset prices. This may produce shareholders that are "stability-minded" as well as "efficiency-minded." Gordon (2017). This may be the inchoate impulse behind Stewardship Codes and various campaigns against the purported "short-termism" of hedge funds. Yet it is hard to imagine that corporate governance can produce a solution.

(i) We are past the point where firms can provide sufficient social insurance or internalize the adjustment costs of economic change. That is a consequence of the changed competitive environment; governance mostly is accommodative.

(ii) Asset managers have reached their market dominance through a business model that specializes in maximum diversification at lowest cost. They can barely summon a couple dozen governance specialists to produce guidelines, drop by firms on occasion, and decide how to vote in the occasional contested election. The idea of developing a social/economic policy that truly takes on system-wide questions would entail a different level of engagement (and costs).

(iii) The political economy of global capital markets makes it harder to develop locally-based socio-economic solutions. The international nature of ownership and the fluidity of capital flows make it hard for firms to see themselves as having national responsibilities -- yet all politics is national. It might be put as a multiple equilibria story: the threat of relocating operations from one country to another creates a race to the top in producing national regimes that maximize corporate (shareholder profits), but that system can be perturbed through a local national political reaction that shifts into an equilibrium of nationalism, mercantilism, and protectionism. Shareholders collectively may have a stake in stability-enhancing measures, which might include slowing down speed of innovation, or some amount of firm-level internalization of adjustment costs, or, in firm-level provision of general human capital skills, but the corporate governance system -- which focuses on maximizing at the firm level and benchmarking comparative performance at the firm level, certainly encourages free-riding from the provision of such public goods

The Government "Match" to High-Powered Corporate Governance

Is there a way out of this box that does not entail a drastic change in the ownership and control of public corporations?

Here is a candidate: a reformulation in the interaction between government and the firm. At least in the US, no one would expect firms to provide employees with general or technical skills. "Public education"

is the government match, and indeed many have traced American prosperity to the decision to provide universal high school education and opportunities for advanced education. At a time when high-powered corporate governance is a complement to a competitive global environment, the national interest requires an additional complement: a strategy of life-long entry and exit portals for training and retraining, that would be principally funded out of the gains generated by the purported efficiencies of firms managed for maximum competitive advantage. In other words, many of the corporation governance innovations have produced "gains," but the mere satisfaction of the Kaldor-Hicks criterion, while perhaps sufficient from a short term corporate governance perspective, may not be sufficient from a sustainable corporate governance perspective. The government "match" will serve the longterm interests of shareholders as well as the social interest. That is the ultimate appeal.