Fairness, Efficiency and Corporate Governance
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(extremely rough draft)

In this paper we will explore the idea that fairness in relations between capital and labor may be an inherently important feature of a corporate governance structure and one that enhances the productivity of corporate firms. We will proceed in Section I by articulating the basic analogy between democracy in collective decision making and fairness in decentralized decision making. In section II, we will articulate an intuitive ideal of fairness in individual transactions. In section III we will articulate a central puzzle about fairness in voluntary transactions particularly as they occur under incomplete markets. In section IV we deepen the picture of imperfect and incomplete markets. We develop a conception of the corporate form as a response to incomplete markets. And we will deepen this conception by showing how firms, corporate firms and a particular kinds of corporate firm are good institutional responses to imperfect markets. Each of these forms enhances firm value. In section V, we articulate a way of thinking about fairness in corporate governance that employs the conception of fairness we have developed and the idea of imperfect markets to develop a conception of a remedy for unfairness in markets. We will vindicate at least one partial defense of worker participation in corporate governance. Section VI, we will provide a tentative and essentially defensive argument in favor of the view that the remedies for unfairness that we propose may actually enhance long term firm value. We provide an account of this and some empirical evidence for the relationship.

Section I.

Voluntary Agreements and Democratic Participation
At the heart of decentralized decision making in markets and other contexts is the process of voluntary agreement making. If we think about negotiation and agreement making we can think of the purpose of the agreement at two levels. The immediate object of the agreement is an arrangement of rights (understood broadly to include liberties, claims, powers and immunities) and duties among those who make the agreement. The participants can set up a system of rules of interaction, which establish a complex of rights and duties and to which they are committed. Or they can merely exchange rights (and the associated duties) to particular things. The further purpose of the agreement is the production of benefits and burdens among the parties. The parties shape the social world they live in in terms of basic rights and duties and they alter it so as to bring about benefits and burdens that the social world can achieve. We can think abstractly about the benefits minus the burdens as the surplus the agreement brings about above the level of benefits the status quo realizes. The transaction takes place in the context of a prior set of conditions which might be thought of as conditions of the process of transaction. Among these are the absence of force and fraud and other background conditions that enable the participants to treat each other as equals.

When a person engages in making agreements, contracts and other arrangements with other people, she is in effect attempting to shape the social world she will live in. If

a person buys a house, he rearranges the social world in that others are now excluded from this house unless he consents to their coming in and he is able to conduct activities in this particular space with or without others depending on what activities he wants to engage in. He has rearranged the social world in that now there is a space in the world that others can only enter with his consent whereas before there was none. He has revised the relationships he has with others. When a person takes a job, he agrees to work for a certain reward. He has rearranged the social world in that certain others now work with him under certain conditions and resources are transferred to him while he employs his skill in producing with others certain kinds of goods. These different transactions have various effects in shaping the social world the person lives in by altering the rights, duties and powers that different people have in relation to that person. And if we think of the whole series of agreements a person enters into in the course of a life we can see that she shapes the whole social world she lives in through this activity. In some sense a person constructs the conditions of her life through this activity of rearranging the rules in her social world.

But of course, she does this with other people who are also engaged in the activity of shaping their lives with others. The activity of determining her social world is of course constrained by the activities of others both because she has to make agreements with them and because she must respect the social arrangements that others have created. So the social world is an aggregate product of all these different activities of social shaping. In part it is the product of coordination and in part it is the product of separate activities that are not coordinated but that mesh together because the activities are engaged in side by side and within the context of a common legal system. But it is also a product of conflict of interests as well since the content of the agreements are normally partially a function of the bargaining power of the participants and each person is constrained by the agreements that others have made.

In this way we can see that there is an important similarity between the activity of citizenship and the activities of persons in the processes of agreement making with others. Just as a citizen participates in shaping the overall character of the society he lives in by participating in collective decision making about the overall collective features of the society so the ordinary person in everyday life shapes parts of the social world in which she lives by engaging in agreement making with others. The difference being that in the case of citizenship each has a small voice in a very large activity while in private life each has a large voice in relatively small issues.

The justification of these different powers of shaping the social world is grounded in the same common liberal concerns. Persons have different interests that conflict sometimes and we give each person some power to pursue those interests and persons disagree on how best to shape their social worlds. Furthermore, there is at least a basic dimension of these issues about how best to shape the social worlds that we do not think ought to be decided by expertise. We think that people ought to be able to make the basic decisions about how their society is organized and how their lives with others are organized on the basis of their own judgments. This is the common core of liberalism at the root of democracy and liberal rights. So we make sure that each has the power to advance her legitimate aims in accordance with her own judgments. In effect democratic decision making and individual decision making in liberal democratic societies are animated by the idea that it is important to give people power to work out the conditions

under which they live. In one case, they are meant to provide people with the power to participate in centralized decision making and in the other they are meant to give people power to engage in decentralized decision making. And in both traditional democratic decision making and in voluntary exchange there are dimensions of both cooperation and conflict. This is one important thing the analogy with democratic collective decision making brings out.

Note that this thesis of the analogy of democratic citizenship with the activities of persons in decentralized settings is not meant to imply that these decentralized settings ought to be centralized and democratized in the traditional way. Our intention is to show that there is an analogy between democratic citizenship and the activities of persons in decentralized settings, not to suggest that we should eliminate the decentralized settings. In fact we think that there are many important values that are realized in decentralized settings that make them unsuitable for collectivization. The values involved in personal relationships and development and the distinctive values that arise from people cultivating their particular talents and ideas must be given some significant protection from collectivization. And we think, with the tradition of economic theory of Adam Smith and John Maynard Keynes, that some kind of open market system is important for putting resources to productive uses.

But the analogy will shed light on how we ought to think normatively about voluntary exchange. The basic idea is that since there is an analogy between participation in centralized decision making and participation in decentralized decision making, that the norms of fairness that are important for evaluating centralized decision making can be extended in some way to the process of decentralized decision making. And as we will see in the penultimate section, it can give us some guidance as to how to remedy the typical forms of unfairness that arise in markets and other decentralized settings.

Section II.

Fairness in Individual Transactions

Christiano has defended in other work a conception of fairness in individual exchange. The view attempts to avoid the classical natural law approach of equal exchange in value and attempts rather to develop a more procedural conception of fair exchange that goes beyond the standards of absence of coercion and fraud. The reason for the procedural approach is that the benefits of transactions can be quite heterogeneous and hard to compare outside the points of view of each of the participants. So it may be very unclear in many circumstances whether the goods exchanged are equal in value in some more objective sense.[1]

If we take an individual exchange as if there were only one exchange for each person's whole life, then the appropriate background fairness conditions for such an exchange consist in the realization of equal capacities for that exchange. This breaks

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[1] The classical version of equality in exchange is Aristotle, *Nicomachean Ethics* book V. See also Thomas Aquinas, *Summa Theologica* II – II. Marx may also be committed to this ideal of equality in exchange. Alan Wertheimer is the contemporary defender of a version of this view in *Exploitation* (Princeton: Princeton University Press, 1996).

down into two components: equal cognitive conditions including equal access to information relevant to one's interests and concerns and abilities to negotiate desirable arrangements, and robust equal opportunity for exiting or refusing entry into the arrangement.

When we extend the principle to the usual case in which each person engages in a series of many exchanges, the persons must have equal capacities globally in the sense that they start from background conditions that ensure equal capacities for all. This equal background condition need not be fully maintained throughout the series because earlier agreements persons have entered into may curtail opportunities they might have had in later agreement making. If this is done knowingly, the later agreement making in which there may be some inequality of opportunity is not unfair. Furthermore, individuals may choose to focus on some agreements in which they think of themselves as having much at stake and focus less on other exchanges in which they think of themselves having a lot less at stake. This stake sensitivity in agreement making will have some importance later.

Thinking in terms of the analogy above, this realizes a kind of democratic value in everyday life because the two conditions in the one shot case in effect specify circumstances in which persons have an equal say in the structuring of their relations with each other. They specify a kind of condition of global equal bargaining power between parties such that each person has an equal say in the formation of the contents of the series of agreements they enter into. And the global principle of equal capacity gives persons a kind of equal say in the formation of their social lives together with others.[2] This will not imply equal bargaining power in each agreement making context but only in some sense over the total amount of agreements a person enters into.

This principle of equal capacity is meant to give persons equal power in the process of the creation of the informal social world they live in. This is partly justified because their interests are roughly speaking equally at stake in the system of agreement making overall. This is like the idea of equality in democratic collective decision making in which person are to have equal power because we think that, for the most part, their interests are equally in play in the political system.

We achieve this condition of equal power by making sure that people have the resources that enable them to exit or refuse transactions and enter others that advance their interests. Education, basic needs provision, and other goods give people opportunities to choose among transactions by enhancing their bargaining power.

The principle of equal opportunity for exit is meant to be a special principle for societies like the modern nation state in which there is a rough equality of stakes for persons overall in the process of agreement making, at least for the great majority of people. There are a number of qualifications that need to be explained concerning this principle. First, since it is a principle of equal opportunity we need to say something about what kinds of things can produce inequality in the outcomes of the processes of agreement making. One, is that those who knowingly exert themselves and make use of their opportunities for the sake of a particular good are more likely to achieve that good, other things being equal, than those who knowingly do not exert themselves for the sake of that good. This is a fairly traditional egalitarian concern. The outcomes of the process

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[2] See "Equality, Fairness and Agreements," *Journal of Social Philosophy* December 2013.

of agreement making can be unequal in important dimensions. A more controversial and complex inequality generating phenomenon is variation in natural talent. It makes sense for differences in natural talent to bring about at least certain kinds of inequalities. This is to agree with Rawls's conception of fair equality of opportunity which allows for people of different talents to arrive at different positions of social power. Rawls does not accept that differences in talent should bring about differences in income or wealth per se. But he does seem to accept the idea that they can bring about differences in social position. So two people who are competing for a particular social position may justly end up in different positions in the division of labor if their natural talents imply that they should occupy those positions, even if in some sense one of the positions is more desirable and interesting than the other. The question is, what can justify this? It can be justified by the principle that we ought to think that generally beneficial inequality can be justified over equality in which people are worse off and by the idea that it is important that people be able to realize their talents. The realization of natural talent implies that persons are benefited when they exercise those talents. To require that people not be able to exercise their talents so that they have no more bargaining power than others would be to make others worse off as well as the person who is deprived of the opportunity to exercise talent.[3]

The Proportionality Principle

The second observation is that the principle of equal opportunity is really a special case of a more general principle. The more general principle is that persons ought to have a say in a transaction in proportion to the legitimate stakes they have in the transaction.[4] The principle of equal opportunity is a principle that respects this more general principle for the special case of equal legitimate stakes.

Let us introduce some terminology that will be of some importance as we go on. The stakes a person has in an agreement or set of agreements consists of the range of potential legitimate interest affecting outcomes of that agreement. This will include the effect on interests if there is no agreement and the effects on interests of the various agreements available in the circumstances. We must distinguish between different ways of conceiving of the stakes a person has in a transaction or in a system of transactions. On the one hand there are what we will call the <u>*ex ante* stakes</u> a person has in a transaction or system of transactions. This is just the extent to which the transaction or the system can advance the legitimate interests of each party independent of the distribution of resources among the parties. This will vary according to context in the sense that it depends on the real possibilities of the system or the transaction. On the other hand there are the <u>actual stakes</u> in a particular transaction. This will depend on the interests in the transaction as well as the distribution of resources among the parties,

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[3] This is not to say that persons having more interesting jobs because they are more talented than others is entirely just. We think there is still some injustice here but it may be more just than the leveling down alternative.

[4] See Marc Fleurbaey and Harry Brighouse, "Democracy and Proportionality," *Journal of Political Philosophy* 2010 for an articulation of this principle in the context of democratic theory. They think of this as the more general principle of which democracy is a special case.

which will determine what each party brings to the transactions. In the context of a particular transaction, a person with very few resources will have higher actual stakes in the agreement because she has less resources to fall back on or to offer others in alternative transactions. The transaction matters all the more. A person with a lot of resources has less need of the particular transaction and so has a lesser stake.

In collective decision making processes, the basic determinant of stakes is the range of alternatives that are plausibly achievable by collective decision making. We see the application of proportionality in collective decision making in the context of federal systems in which for many issues everyone has an equal say but for some, local, issues some have more of a say than others. The basic determinant of relative stakes in the case of voluntary exchange is a bit different than in collective decision making. This is because voluntary agreement making has two separable components: whether to make an agreement at all and what the content of the agreement should be. The basic determinant of stakes in voluntary agreement making is the relative significance of the non-agreement point. This means that how much a person benefits from an agreement need not determine stakes. The reason for this is that the way the surplus of the agreement is divided up will depend on what the parties agree to. But the initial condition of the agreement, which are the values or disvalues of no agreement for each of the parties is in some sense external to the agreement and thus can provide a kind of external reference point for determining the stakes of the agreement.

The principle of equal capacity is based on the idea that persons have equal ex ante stakes in a system of transactions overall. It then requires that the distribution of resources be adjusted so as to achieve equal capacity. This is a special case of the more general principle that persons ought to have capacities that are proportionate to their ex ante stakes. Someone who has a lot less stake in a transaction, ought to have less power over it than the one who has more stake.

This is a fairly standard way of thinking about agreements. Intuitively, when we are setting up an arrangement with another person who we know well and we know that the other person has a lot at stake while we have less at stake, we often give more say to that person over the arrangement. "This matters more to you [or for you], so you should decide."

There are three points here that should qualify the above principle. The first two mimic the qualifications to the equal opportunity principle. First, the proportionality is a global principle and not strictly a local one. There may be particular circumstances in which a person may have higher stakes but a lesser say because of previous choices the person made knowing that it would produce circumstances that the person found themselves in. The person may have knowingly limited the range of options available to him at the later stage by an action he performed at an earlier stage. The second qualification is that if a person has more say because they have more natural talent, there is no practical objection.

The third qualification results from a worry, pointed out by Nozick, that this gives people power over the intimate choices of others. If one person loves another deeply and the other chooses to marry a third person, then the first person has great stakes in the second person's choice. Does this mean that the first person ought to have a say in the choice? This seems really implausible. We should allay this worry with the idea that some interests are protected interests in the sense that a person may choose to fulfill these

interests without the leave of others. This might be the case for example in choices of friends or life partners and perhaps choices about basic questions of conscience.[5]

Some Central Cases in which the Proportionality Principle Applies

But the reason for emphasizing the general principle of proportionality to stakes is that there are important contexts in which persons or groups come together to make important agreements but where they are not really part of an extensive and unified system of agreement making. The key kinds of cases like this arise mostly in the context of increasing globalization. There are three main types. The first is the case of agreements among states on treaties or arrangements between them. The extent of agreement making among states in the making of international law is fairly modest compared to the domestic legislation states engage in and relatively modest compared to the amount of agreements individuals enter into in modern societies. The second consists of the contractual arrangements people enter into across different societies such as when a firm sets up shop in a poor country to employ relatively cheap labor.

The third consists in societies in which there is great inequality of opportunity among persons and where these persons who have very different opportunities enter into contractual arrangements with each other. The most basic case of this in the modern world is the relation between capital and labor. The basic reasons for this are the great inequalities of education and other social circumstances that characterize the difference between owners and managers of capital and ordinary workers. Another reason is that capital is much more mobile than labor is and thus has much better non-agreement points than labor, in general. We seem to be witnessing increasing inequalities in these ways between owners and managers of capital on the one hand and ordinary workers and their families on the other.

Argument for the Proportionality Principle

The proportionality principle is an intuitive principle. There are really two main connected theoretical arguments for this principle. The first argument is essentially a welfarist argument. The idea is that people have an important interest in taking care of their own interests. The basic reasons are that they know their interests better than others do, they have incentives to concern themselves with their own interests and they have the capacity to learn from mistakes about their own interests. To the extent that more is at stake in an agreement for a person than for others, they have more of their interests at stake and so there is reason for them to take greater care. But this also gives reason to others to give them a greater say in the agreement. The welfare of persons is better advanced when they have a greater say in those issues in which they have a greater interest.

There is an egalitarian argument for this as well at least under normal circumstances with normal people. The idea is that a principle that extends a greater say to those who have more interests at stake in agreements, will over the long run equalize the say of persons over the matters that affect their interests. This is based on the idea that over the long run normal people have roughly equal stakes in how the external world

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[5] (in *Anarchy State and Utopia* [New York: Basic Books, 1974])

is organized. So the thought is that the principle in effect gives people a kind of equal say over the external world they live in when we think of its global application.

One question that we cannot address here is whether the principle we are defending is essentially an instrumentally defended principle or whether there may be some intrinsic value to implementing the principle. The arguments above suggest an instrumental cast to the argument but the democratic interpretation of equality of opportunity offered above suggests that there could be some kind of intrinsic value in implementing the idea.

Section III.

The Puzzle

One of the most fundamental practical puzzles in a system of free transactions is that the principle of power proportionate to stakes is necessarily violated under some quite normal conditions of exchange. For example if you have two persons who depend on making an agreement to advance certain interests, the one who has the least stake will often have more power. This is because they can more easily afford no agreement. But this means that power is often inversely proportioned to stakes in a scheme of free transactions, while the normative principle tells us that power ought to be proportioned to stakes.[6] This is the fundamental puzzle that Marx pointed to in the relations between capital and labor. The laborer has a great deal at stake in a transaction since her life depends on it, while the capitalist has a lot less at stake. The consequence is that the capitalist has more bargaining power and can deprive the laborer of all but the basic means of existence.[7]

A scheme of equal opportunity attempts to avoid this in the following way. It attempts to rectify the kinds of resource differences that produce this kind of actual inequality of stake in order to equalize capacity so as to apportion capacity to ex ante stakes. Now, in a particular transaction, if two parties have roughly equal capacity overall and one party has more at stake actually than another because of difference of interest, the usual consequence is that the one with less at stake will devote less attention to the issue (in order to devote more time to other issues) while the one with more at stake will devote more time. This happens in democratic decision making as well. In this way, the overall proportion between capacity and interest is maintained. What Marx was concerned with was that the capitalists, who have less actual stake in each particular transaction with a particular worker, also have much more resources to devote to the making of the transaction. This compounds the initial disproportion. We will see later how this problem occurs in the case of the transactions among states in the creation of a regime of international trade.

The Puzzle in Markets

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[6] This basic idea is developed in significantly more detail in Christiano "The Tension between the Nature and the Norm of Voluntary Exchange," (in *Southern Journal of Philosophy* Supplement on Exploitation December 2016)

[7] See Karl Marx, *Capital* vol I

It looks like this problem does not occur in perfectly competitive and complete markets. In markets where there are lots of buyers and sellers and no impediments to exchange and there is no incompleteness so that credit and insurance are available to everyone it is not clear that a genuine inequality of stakes can obtain and thus it is not clear than any difference in bargaining power can obtain. And it is not clear that differences in endowments make any difference to life prospects in complete markets given the unlimited availability of credit and insurance as well as the absence of asymmetries of information. So the puzzle does not seem to appear in the context of perfectly competitive and complete markets. Fairness, by the account defined above, seems to be automatically met in this kind of market. This is an important and interesting result that deserves further study.

The puzzle is nevertheless a deep one because in fact we always observe significant divergence from both completeness and perfection in markets. And many of the principal institutions in what we call the market are specifically designed to overcome imperfections in actual markets. Indeed, one of the central institutions of modern capitalism, the firm, is essentially a response to market imperfections.[8] At the same time some form of a system of voluntary transactions is a highly effective tool in figuring out how to allocate resources to their most productive uses. We do not have a clear idea of an alternative system for the allocation of scarce resources that does not involve the use of voluntary market exchange playing a central role.

So the question is, how can we make use of this tool for allocating resources in an efficient way but without sacrificing fairness? There are really four basic kinds of mechanisms that we can introduce to try to ensure a kind of fairness in the process of making agreements. The first is redistribution so as to achieve a kind of background distribution of resources that enable people to meet each other on reasonably equal terms. The second is direct regulation of the employment relation as in minimum wage, safety and hours regulation. The third is direct regulation of the bargaining process so as to help achieve a kind of balance in the bargaining process. The fourth involves some kind of partial collectivization in the decision making in economic institutions. Here we replace bargaining with collective decision making among the parties and try to achieve equality in the collective decision process. We can think of a number of institutions that might help to alleviate the disproportionality involved in voluntary transactions. The mechanisms of redistribution, regulation of employment, regulation of bargaining and collectivization can be seen as complementary in significant part. We will look more closely at the theoretical ground for these remedies in Section V.

Section IV.

Corporate Governance and Markets

In this section, we examine more deeply the idea of market imperfection in the context of firms. First we will characterize the kind of market in which corporations operate. The

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[8] See Ronald Coase, "The Nature of the Firm," in *The Firm, the Market and the Law* (Chicago: University of Chicago Press, 1988) and Oliver Williamson, *The Economic Institutions of Capitalism: Firms, Markets and Relational Contracting* (New York: Free Press, 1985) for the seminal discussions of the nature of the firm.

principal idea here is that we are dealing with imperfect and incomplete markets in which it makes sense to introduce institutions rectify difficulties that arise in imperfect and incomplete markets. Second we observe that the firm is itself a response to market imperfection. Third, we observe that market imperfections also create the need for thinking about corporate structure in a way that diverges from the standard shareholder primacy approach. Fourth, we discuss the specific case of fairness in the relations between capital and labor and discuss how certain corporate governance structures may be an appropriate response to market failures in this domain.

Imperfect and Incomplete Markets

General equilibrium analysis attempts to explain how prices coordinate the activities of an entire economy—including production, exchange, and consumption activities—in a way that leads to an efficient allocation of resources. In perfectly competitive and complete markets, there is a complete set of contingent markets that allows the buying and selling of claims on any good at every future point of time and in all possible economic circumstances. This requires complete information about the present and future among the participants. It requires the absence of externalities, and transaction costs.

The market structure observed in the real world, however, is quite distant from the idealized structure of complete markets in which everything is tradable in advance.[9] Among other factors, transaction costs, non-verifiable symmetric information, and asymmetric information limit existing insurance opportunities.[10] This has many repercussions for how economic life ought to be organized.

First, many have observed that the existence of the firm itself is a response to market imperfection. It is a response to the costs of actually engaging in the kinds of transactions that people must engage in in the case of complex productive and transactional activities. The firm in effect replaces a large number of individual transactions with a hierarchical structure of decision making that is designed to avoid the transaction costs of having to negotiate every single interaction that takes place in a complex economic endeavor. In perfect and complete markets, these do not pose a problem. But where there are significant transaction costs and significant incompleteness of information, the hierarchical structure of the firm greatly improves upon the state in which every transaction must be completely negotiated in a world in which there are scarce resources for negotiation.

Second, the corporate form itself is a response to imperfections in markets. The corporate form involves lock-in capital, transferable shares, limited liability and centralized management. Lock-in capital is redundant under complete markets. Capital investors don't need to lock-in their capital. A system where investors can withdraw capital (at will) would perfectly work. Lock-in capital is necessary for two reasons. Investors may want to withdraw capital for: Consumption needs and Asymmetric information.. But under complete markets investors can buy a state contingent set of

9. Jacques H. Dreze, *(Uncertainty and) The Firm in General Equilibrium Theory*, 95 ECON. J. 1, 1 (Supp. 1985) (Conference Papers); Jean-Jacques Laffont, *A Brief Overview of the Economics of Incomplete Markets*, 65 ECON. REC. 54, 54 (1989).

10. *See* Jean-Jacques Laffont, *A Brief Overview of the Economics of Incomplete Markets*, 65 ECON. REC. 54, 54 (1989).

Arrow securities and buy full insurance against future consumption shocks. Transferable shares is also redundant, this feature is not required without lock-in capital. Because capital is locked-in, investors may need to cash their investments for consumption shocks. Limited liability is redundant under complete markets. Investors can write a set of complete contracts specifying the level of individual liability based on their risk preferences. Limited liability emerges because of incomplete contracts (i.e., another source of market incompleteness). Centralized management is redundant under complete markets. Under complete markets, (benevolent) investors can directly run the firm and always reach unanimous decisions. This is because investors have: (i) the same information; (ii) perfect hedging against future consumption shocks; and (iii) no collective action problems. They will always agree on business production decisions as is expressed in the Fisher separation theorem. In brief, we observe the corporate form because markets are incomplete; the first and second welfare theorems do not hold.

Simone Sepe and Martijn Cremers have argued in addition that market imperfections supply considerations in favor of further modifications of the corporate form. They have argued that because of imperfections in the pricing of assets along with the inability of shareholders to commit to long term corporate policies, corporations that are governed primarily by shareholders are less productive and valuable than corporations that empower boards by giving them some insulation from shareholders.

The conventional view is that shareholders unanimously favor (expected) high-profit production plans over (expected) low-profit production plans and that the only residual issue is the question of how to best induce board and managers not to deviate from the firm's objective maximization function. In the environment of perfectly competitive and complete markets, the Fisher Separation Theorem illustrates that the production function (i.e., a firm's choice of investments) becomes independent of shareholder preferences. Accordingly, a firm's profit maximization function is once again objectively defined as the maximization of that firm's net present value.[11]

Under the more realistic assumption of *incomplete* markets, the argument that production is independent of shareholder preferences breaks down, as shareholders can no longer rely on fully contingent contracts to insure their future consumption needs. How to practically manage the firm's assets and opportunities under "profit maximization" becomes a subjective decision, which varies with shareholder preferences.[12] Consequently, shareholder disagreement may occur—as evidenced by the fact that one does not generally observe unanimous shareholder deliberations—causing equilibrium security prices to no longer be uniquely defined. Research on specific investment criteria in the context of incomplete markets has accordingly concluded that

11. IRVING FISHER, THE THEORY OF INTEREST 141 (1930).

12. *See* Peter M. DeMarzo, *Majority Voting and Corporate Control*: *The Rule of the Dominant Shareholder*, 60 REV. ECON. STUD. 713, 714 (1993); Sanford J. Grossman & Oliver D. Hart, *A Theory of Competitive Equilibrium in Stock Market Economies*, 47 ECONOMETRICA 293, 293 (1979).

even the most promising forms of shareholder economy result in inefficient allocations,[13] unless it is possible to artificially replicate a mechanism of full insurance.[14]

As explained by Keynes through his influential metaphor of financial markets as a beauty contest,[15] rational herding behavior may induce investors to react to aggregate market demand rather than to their own information, because "each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors."[16] Understanding market prices thus requires not just an understanding of all market actors' average expectations about future liquidation value, but also an understanding of all market actors' beliefs about other market actors' beliefs (that is, higher-order beliefs).[17] Because consideration of higher-order beliefs incentivizes an excessive reliance on public information, the mean path of prices may depart from the consensus estimate about the fundamental value of a firm, negating the predictive power of even the semistrong form of the Efficient Capital Markets Hypothesis.[18] Speculative factors unrelated to the true value of market assets may also push prices away from fundamentals.

Once one takes into account the possibility of a Keynesian market, prices cannot be safely relied upon to get shareholders past the barrier of asymmetric information. This is especially true for corporate production involving the development of nonstandardized, innovative technologies, particularly where that production relies heavily on firm-specific employee investments. Indeed, information about the long-term value of these investments tends to be "soft"—mostly limited to firm insiders—and hence less accurately reflected in market prices.[19] By contrast, channeling resources to such investments tends to require large capital expenditures in the short term, which necessarily decreases a firm's current earnings. This decrease in present earnings is a type of "hard" information that the current stock price can more easily incorporate. As a result, shareholders are more likely to misinterpret a short-term drop in profits as a sign of underperformance, when in reality it reflects the expenses of an investment whose value will not be realized immediately.

The possibility of informational inefficiency affecting shareholder evaluation of managerial actions helps explain why short-termism is likely to be a much more severe problem than the corporate law scholarship typically acknowledges. Economically, a

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13. *See* J. Geanakoplos et al., *Generic Inefficiency of Stock Market Equilibrium When Markets Are Incomplete*, 19 J. MATHEMATICAL ECON. 113 (1990); Michael Magill et al., *A Critique of Shareholder Value Maximization* 1 (Swiss Fin. Inst., Research Paper No. 13-16, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2246797.

14. *See* Jacques H. Drèze, *Investment Under Private Ownership: Optimality, Equilibrium and Stability*, *in* ALLOCATION UNDER UNCERTAINTY: EQUILIBRIUM AND OPTIMALITY 129-30 (Jacques H. Drèze ed., 1974).

15. *See* JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY (1936). J. Michael Harrison & David M. Kreps, *Speculative Investor Behavior in a Stock Market with Heterogeneous Expectations*, 92 Q.J. ECON. 323 (1978); José A. Scheinkman & Wei Xiong, *Overconfidence and Speculative Bubbles*, 111 J. POL. ECON. 1183 (2003).

16. KEYNES, *supra* note13, at 156.

17. Franklin Allen et al., *Beauty Contests and Iterated Expectations in Asset Markets*, 19 REV. FIN. STUD. 719, 720-21 (2006). Philippe Bacchetta & Eric Van Wincoop, *Higher Order Expectations in Asset Pricing*, 40 J. MONEY, CREDIT & BANKING 837, 838-39 (2008); Bruno Biais & Peter Bossaerts, *Asset Prices and Trading Volume in a Beauty Contest*, 65 REV. ECON. STUD. 307, 307-09 (1998).

18. Giovanni Cespa & Xavier Vives, *Dynamic Trading and Asset Prices: Keynes vs. Hayek*, 79 REV. ECON. STUD. 539, 539-40 (2012).

19. JEAN TIROLE, THE THEORY OF CORPORATE FINANCE 250 (2006) (defining "soft" information).

commitment problem arises each time decision-makers have incentives to renege on prior engagements where the anticipation of this circumstance reduces ex-ante welfare. Something similar happens in the corporate context when shareholders cannot credibly commit to value-increasing long-term investments. In an attempt to maximize the value of their holdings—and unable to tell whether a short-term drop in firm outcomes reflects mismanagement or an investment that is slow in paying off—shareholders will either seek a change in investment policy through board removal or dump their shares, increasing the likelihood of a change in control.[20] In either case, directors and managers risk losing their jobs, with the result that they rationally develop "myopic incentives,"[21] passing up profitable long-term projects that are more likely to be mispriced or overinvesting in less profitable short-term projects. In a sense, the lack of shareholder commitment induces managers to make the decisions that an uninformed market wants to see.

Individual investors now mainly hold their equity interest through a set of intermediary institutions. Additionally, the rise of activist hedge funds has reduced the classic shareholder collective action problem, thereby giving new significance to shareholder governance. From an asset-pricing perspective, these transformative changes seem to point to a higher likelihood of Keynesian prices, as they increase both the likelihood of herding and speculative behaviors. In an environment where institutional investors' performance is evaluated in relative terms over fairly short periods, "beating the market" is now the common imperative.[22] Under this imperative, herding is likely to be a defining market feature, because computing the beliefs of other institutional investors emerges almost as an intrinsic need when an investor's portfolio is evaluated against a competitive benchmark.

A party's ability to unilaterally renegotiate the terms of a contract is a special kind of renegotiation. In particular, the relationship between shareholders and firm insiders (i.e., directors and managers) fits this contractual paradigm, as shareholders can remove directors and top management or simply sell their shares, which may trigger a change in control and the replacement of incumbents. On this reconceptualization of shareholder-manager relationships, the shareholder limited-commitment problem thus emerges as the combined result of asset-pricing imperfections and unilateral renegotiation rights.

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20. This description of the dynamics underlying the shareholders' limited-commitment problem is consistent with investors' average holding periods. *See, e.g.*, Patrick Bolton & Frédéric Samama, *L-Shares: Rewarding Long-Term Investors* 3, 43-44 (European Corp. Governance Inst., Finance Working Paper No. 342/2013, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2188661 (documenting the existence of increasingly shorter average holding periods by investors from 1960 to 2005). Dominic Barton, *Capitalism for the Long Term*, HARV. BUS. REV., Mar. 2011, at 85, 86.

21. Jean-Jacques Laffont & Jean Tirole, *Repeated Auctions of Incentive Contracts, Investment, and Bidding Parity with an Application to Takeovers*, 19 RAND J. ECON. 516, 529-31 (1988); Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655, 656-61 (1989); Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61, 62-67 (1988) (showing formally that managers of a firm threatened by a takeover will sell an underpriced asset).

22. Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 889-90 (2013).

Given the trade-off posed by the competing problems of managerial moral hazard and lack of shareholder commitment, it makes sense to proceed by attempting to understand which problem should be granted priority over the other.

First, the risk of short-termism is especially pronounced for corporate production processes that involve the development of non-standardized, innovative technology and that rely more on specific human capital contributions.

Second, the corporate contracts of the firm's various stakeholders—including suppliers, consumers, workers, and creditors—are also subject to the threat of unilateral shareholder renegotiation. In a classic hold-up framework,[23] ex-post renegotiation causes the stakeholders' corporate investment to lose value—the more specific their investments, the more value they lose. This potential for hold up distorts ex-ante incentives to invest optimally in the firm, inducing stakeholders to increase the cost of their corporate performance and/or reduce the level of their investment.[24] As with short-termism, the ultimate result is reduced firm value.

In the case of employees, for example, the employer's right of at-will termination leaves significant room for the exercise of discretionary power and is, therefore, subject to shareholder influence via renegotiation. It appears to be no coincidence, then, that a standard governance intervention technique of activist hedge funds is to cut the cost of labor by reducing the number of workers.[25]

From a trade-off perspective, however, the question remains whether the benefits of board insulation come at the expense of a higher risk of directorial or managerial moral hazard. Empirically speaking, our results do not show such a linkage. Indeed, the positive time-series association of staggered boards and firm value indicates that any potential increase in costs due to managerial moral hazard is generally more than compensated for by the benefits accruing from committing shareholders more strongly to long-term investment projects.

Section V.

Remedies for Unfairness in Markets

We have articulated the analogy between centralized decision making and decentralized decision making. We have articulated and defended the basic principle of fairness for decentralized decision making (again on analogy with fairness in collective decision making). We have articulated the fundamental practical puzzle concerning the tension between fairness and the nature of voluntary exchange. And we have deepened the picture of market imperfection and incompleteness with respect to firms. Here we want

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23. A hold-up problem occurs "when a transactor . . . decides it is wealth-maximizing to take advantage of contractual incompleteness to expropriate the rents on the specific investments made by its transacting partner." Benjamin Klein, *Hold-Up Problem*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 241, 241 (Peter Newman ed., 1998).

24. Lynn Stout has proposed a similar ex-ante/ex-post perspective to analyze the effects of antitakover defenses, criticizing past empirical studies for failing to consider the ex-ante benefits of having such defenses. *See* Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845, 853-56 (2002).

25. *See, e.g.*, Alon Brav et al., The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes 19-22 (Jan. 2015) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2022904.

to articulate a basic way of thinking about how to solve the practical puzzle in voluntary exchange.

The idea is that the capacity for exit and cognitive capacities give power to a person over the formation of the social world in the context of decentralized decision making while votes and opportunities to influence the processes of deliberation and negotiations give power over collective decision making. And the idea is that the egalitarian principle in play in the justification of the principle of political equality in democracy can play an analogous role in the justification of a robust conception of equality of opportunity in the context of decentralized decision making.

This idea will play a significant role in what follows. For it suggests that a loss of power with respect to exit can be compensated for by means of a gain in power in voice. We will call this the remedial principle. The idea is that both the power of exit and the power of voice are powers that enable one to shape the social world one lives in. So if a person has a very low and unjustly distributed power of exit and that power of exit cannot be improved for some reason, then one can enhance that person's ability to shape the social world they live in by giving them some kind of voice in the activities from which they have a diminished power to exit. If the two kinds of power are really about the same kind of thing, then one should be able to remedy a deficit in one by increasing the amount of the other.

Of course, this is not the only way to improve the situation of a person with diminished power of exit. One can also diminish the power of exit of the counterparty say by employment regulations or by collective bargaining and thereby enhance the say of the initial person. And of course one can improve the capacity to exit by improving the alternative opportunities of the person through the welfare state.

This does not imply that exit and voice need to be substitutes. They obviously can complement each other as well. This is what happens in the case of persons with a great deal of bargaining power or capacity for exit. They often establish a greater voice for themselves in the enterprise in which they participate. So all four remedies (welfare state, employment regulation, collective bargaining and worker participation) can complement each other.[26]

It is important to note a distinction between global voice and local voice here. A person has a kind of global voice to the extent that they can participate in collective decision making with regard to the whole society they live in. This is the traditional avenue of democratic politics. A citizen in a democratic society has a voice in global decision making regarding the global properties of the society. Local voice is voice in some more particular cooperative activity in which one participates. Being on the governing board or being represented by someone on the board of a corporation gives one local voice over that small part of society that the board controls. Voice in a university department gives one voice over elements of one's working environment and hiring. This is also local voice.

It is the enhancement of local voice, and not global voice, that is the appropriate initial remedy for the diminished power of exit in decentralized decision making. That is, if we are assuming an environment in which we want there to be decentralized decision

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[26] Indeed they seem to stand together in social democratic countries such as Germany, Sweden, Denmark and Norway.

making, as in the case of markets, then enhancement of local voice is at least the initial response to a hard-to-change diminished power of exit. Local voice is what enhances a person's power to shape the local social world she lives in, which power is diminished by diminished power of exit.

These concepts and principles become salient in the context of imperfect and incomplete markets. Recall that in perfectly competitive markets that are complete, everyone is a price taker and to the extent that markets are complete, everyone has unlimited access to credit to enable them to take advantage of opportunities and insurance to protect against future eventualities.

In perfectly competitive markets over limited numbers of goods but in which each has an equal endowment, each has a kind of equal power determined by their equal endowments. It is important to note that even here each person has the power of exit that enables them to secure the arrangements they desire even though no person has bargaining power over arrangements relative to anyone else. Exit power here merely refers to the set of available alternatives a person has. In perfectly competitive markets with limited types of goods, a person has greater alternatives available to them and thus more exit power when she has a greater endowment. Equality in this case amounts to equalization of endowments. In the case of perfectly competitive and complete markets, each person's power is essentially the same, or at least this is what we are assuming here.

It is when we move from perfectly competitive markets that are complete or egalitarian to imperfectly competitive and incomplete markets in which endowments are unequal that we see very different capacities for exit among persons. In the context of imperfect markets, some have greater bargaining power to determine the contents of the agreements they enter into with others as a result of different capacities for exit. Some have the capacities to determine the contexts in which others live.

The easiest case to see this is in labor markets that have some degree of monopsony so that employers have some bargaining power with respect to workers. This may be because it is quite costly for workers to go from one job to another or because they have low levels of information about other jobs while employers do not see the same difficulties. In this kind of context, the market imperfections involve asymmetries of information or relatively high transaction costs for workers. The result is that they take jobs at relatively low wages and poor working conditions. Their diminished capacity of exit gives them relatively weak power to determine the conditions under which they work and live.

Many of the actions of the firm are experienced partially as external effects by such workers, since they have little say over the circumstances of employment. And of course, if the workers have no say in the firms' activities then mistakes in production or risks that have gone bad, which may result in laying off workers are experienced as external effects. They must suffer costs that others have created.

Again, to be sure, workers have consented to be members of the relevant firm. We don't have to say that workers are "forced" to take the jobs but they have relatively low levels of power because their capacities of exit are relatively curtailed. But the conditions we are describing are such that they consented under conditions in which they have little power. To the extent that these conditions are unjust, because they reflect a background distribution of power that is unequal, there is a need to remedy the injustice by enhancing the power of the workers.

This is, we think, a singular virtue of the democratic conception. One of the main traditional approaches to unfairness in transactions states that a transaction is unfair to the extent that it is involuntary. This suggests a kind of threshold conception of voluntariness. And this raises a lot of questions about what voluntariness consists in. And debates easily become verbal disputes about what is and what isn't voluntary. The voluntary has been defined in terms of absence of rights violation (Nozick), or absence of coercion and fraud (Bigwood) or absence of acceptable alternatives (Cohen and Wood). We think that there is no threshold effect of this sort except the most extreme form. Otherwise there is continuity. The democratic conception simply says that people can have more or less power to determine the arrangements they live under and says that equality is the fundamental principle by which to assess the distribution.

Once we see the issue as one about the distribution of power over the social world we do not need to show that the workers have not voluntarily consented to the conditions of work by some complicated conception of voluntariness. What we need to show is that they have relatively little power compared to those who are running the firm. And from this we can infer that they are being treated unjustly if we apply the democratic principle to the case.

The key further move here is then to suggest that we can rectify this inequality of power in a variety of ways. We could have attempted to generate ex ante an equal distribution of power. We could use the welfare state to do this by ensuring that workers have adequate endowments to fall back on if they find working conditions problematic. Notice here that the welfare state institutions are not merely conceived as satisfying needs but also as enhancing the bargaining power of workers, which is justified by the democratic analogy.

But the principle of remedy suggests that there are more immediate ways of rectifying the imbalance when it occurs in the way described above. Those would be ways of making up for the deficiency in exit power by increasing local voice power. So, to the extent that the employer employee relation is one of monopsony and the distribution of exit power is an unjust one, the situation can be made more just by giving workers rights to participate in the running of the firm. This might be in terms of working conditions, wages, and even investment decisions. By giving workers under these conditions a voice in the firm, their relative lack of power that derives from poor exit opportunities is remedied by an increase in the power of voice in the running of the firm.

Another possible form of remedy along similar lines would be that the workers are organized as a union in which each worker has some kind of a say. This remedy combines the exit dimension with the voice dimension in an interesting and complicated way.

There are a number of things to note here. First, the argument for workplace democracy, to the extent that there is one, is not a general argument. Workplace democracy is a remedy for a particular set of defects in markets and for a highly unequal distribution of power. But there is continuity here. There are going to be circumstances where the employees have a great deal of bargaining power, even individually. In a sense they have a great deal of say by virtue of their bargaining power. In this kind of case, workplace democracy is not a direct implication any longer of the theory of fairness. And there are intermediate cases, conceivably, in which workers have a significant

amount of bargaining power but still a somewhat unjustly lesser amount of power. Fairness may require some lesser degree of participation in these contexts though it may require some.

Another reason why this is not a completely general argument for workplace democracy is that there are other remedies available for realizing equal power such as union organization, enhancement of the welfare state, and regulation of the employment relation. In some circumstances one of these may conceivably introduce greater equality of power than workplace democracy.

There is another observation here that is potentially of some significance. It involves the explanation for why there are so few worker run firms in particular firms run by workers who otherwise have little bargaining power. The account we are offering in a sense makes this obvious. It is precisely because workers have relatively little bargaining power that they are unable to realize stronger control over their firms. The basic reason for this is that there is a conflict over the rents created by the firm. Management and stockholders attempt to get as much of this as possible. Worker control inevitably ensures that workers secure a larger part of the rents so it is strongly opposed by the stockholders and management. This conflict has been noted by a number of economists who have argued that significant worker control is unlikely to come about even if it is more efficient than the absence of worker control because even if the returns to the firm are higher under some degree of worker control they may nevertheless not be high enough to ensure that management and stockholders win as much or more than under stockholder and management control.[27] So it is precisely in the case in which workers most need, from the standpoint of fairness, some significant degree of control over the firm that they cannot get it. This is an instance of the puzzle we described above.[28]

We think that the argument above may provide grounds, assuming the defensive argument in the next section is right, for introducing some kind of legal requirement of worker participation in certain kinds of markets. We do not have the time to pursue the policy implications in this paper.

Section VI.

Fairness as Enhancing Firm Value

In this final section we consider in only a very rough way the objection that enhancing worker participation may diminish the efficiency of firms. Here we attempt to show that there is some reason to think that fairness may enhance firm value and we give some empirical evidence.

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[27] See Richard Freeman and Edward Lazear, "An Economic Analysis of Works Councils" in *Works Councils* ed. Joel Rogers and Wolfgang Streeck (Chicago: University of Chicago Press, 1995).

[28] This argument is a relative of the argument given by Marc Fleurbaey to the effect that workers are not able to get worker control because workplace democracy is a kind of public good and workers, being significantly worse off than their employers, are always willing to trade off a vote for the sake of some extra income. Marc Fleurbaey, "Workplace Democracy as a Public Good, " *Revue de Philosophie Economique*

Under the standard welfarist account of corporate relationships, there is no role for special institutions to implement fairness. Building on the insights of Jensen and Meckling's agency theory, that account holds that maximizing shareholder wealth is the best way to maximize overall wealth and, hence, the only end that matters in corporate law. An oft-repeated argument in support of this view is that it was the consensus on shareholder primacy that opened the door to empirical corporate governance and the use of shareholder value metrics as measures of corporate governance efficiency. Another frequent argument is that other stakeholders, unlike shareholders, could fully protect their corporate interests by contract. On these premises, importing principles of fairness or justice in corporate law would be redundant, if not inefficient. These principles would only create frictions in the market system, which under the standard account is conceived as approximating the ideal of a complete, neoclassical market.

The standard account, however, fails to consider two important aspects. First, "neoclassical" scholars underestimate the inter-temporal dynamics of the shareholder wealth maximization mandate, while also oversimplifying the relationship between that mandate and the use of shareholder value metrics in efficiency analysis. Without a specification of what the process of creating shareholder wealth involves over time, such a process inevitably turns into a requirement to cater to today's stock price. That requirement, however, ignores crucial inter-temporal issues in the efficiency of market prices. Indeed, only under the assumption of perfectly informative prices (and markets) can managing based on the current market price be assumed to serve the end of overall value maximization. Yet, as soon as we depart from the hypothesis that share prices incorporate all public and private information—a hypothesis that the recent crisis has exposed as unrealistic—managing based on the current price promotes short-termism and other inefficiencies. Further, for similar negative results to arise, one need not assume that market prices are systematically uninformative. It is instead sufficient to assume that market prices are "discontinuous": unable of fully capturing the implications of directorial and managerial decisions until those implications begin to show up in cash flows over time.

Second, the standard account fails to fully consider the nature of the relationship between the capitalists, i.e., the shareholders, and the other stakeholders, i.e., primarily, the workers. This relationship is dynamic in nature. Under this transactional feature, a governance model that empowers shareholders with formal authority over the corporation exposes the workers to a higher risk of hold-up, as it enables them to credibly threaten to renegotiate the employment contract ex-post. This threat will be the more effective, the greater the employee's specific investments, as this makes the exercise of the employee's outside option more costly. Under these circumstances, empowered shareholders will thus be in the position to fully appropriate the "quasi rents" generated by the relationship, at the expense of labor. Dynamically, however, this is not a sustainable equilibrium. As explained by incomplete contract theory, the equilibrium solution of hold-up games is that the parties subject to the risk of hold-up—in our case, labor—will reduce the level of its specific investments, as a strategy to minimize the risk of ex-post expropriation. Viewed through this lens, institutions that implement the principle of fairness emerge as the rational response to incomplete markets and incomplete contracts. Institutions that consciously implement fairness in corporate relationships provide workers with an

insurance against the risk of ex-post expropriation by the shareholders-capitalists. Market contracting cannot offer such insurance once one discards the unrealistic assumption of market completeness. This conclusion has major welfare implications, suggesting that in contexts where (specialized) labor is more important, fairness is also valuable to the shareholders as it enhances labor's willingness to make specific investments, increasing firm value.

1. The Welfare Employee Index and Data Description

We test our central theoretical proposition by constructing an index that measures a company's employee welfare. This index, which we call the *Employee Welfare Index*, is the algebraic sum of the employees' "strengths" and "concerns" (as defined below) we retrieved from the MSCI ESG STATS (STATS) dataset. STATS is an annual data set of environmental, social, and governance ratings of publicly traded companies, which is published at the end of each calendar year in spreadsheet form, and data set begins in 1991.

Employees' strengths are defined as follows:

Union Relations

This indicator captures companies with high union density.

Cash Profit Sharing

This indicator captures companies that have a cash profit-sharing program through which the company has recently made distributions to a significant proportion of its workforce.

Employee Involvement

This indicator captures companies that encourage worker involvement via generous employee stock ownership plans (ESOPs) or employee stock purchase plans (ESPPs).

Employee Health & Safety

This indicator captures companies that have strong employee health and safety programs. Initiatives include efforts to reduce exposure through comprehensive H&S policies and implementation mechanisms across the supply chain, identification and elimination of sources of H&S risk, training, operations and contractors performance auditing, certification under OHSAS 18001, setting up improvement targets, and assessment of historical performance tracking and reporting.

Supply Chain Labor Standard

This indicator evaluates how well companies manage risks of production disruptions and brand value damage due to sub-standard treatment of workers in the company's supply chain. Companies that establish labor management policies meeting stringent international norms, implement programs to verify compliance with the policies, and introduce incentives for compliance among suppliers score higher.

Compensation & Benefit

This indicator captures companies that provide noteworthy employee compensation

and benefit programs.

Employee Relations

This indicator captures companies that provide employee engagement opportunities through collective bargaining or other employee involvement programs, and actively measure employee satisfaction.

Professional Development

This indicator captures companies that provide excellent employee training and development programs.

Human Capital Management

This indicator evaluates companies' ability to attract, retain, and develop human capital based on their provision of benefits, training and development programs, and employee engagement; and avoid labor unrest or reduced productivity due to poor job satisfaction. Companies that proactively manage human capital development through offering competitive benefit packages and performance incentives, implementing formalized training programs, offer employee engagement and professional development programs and actively measuring employee satisfaction score higher.

Employees' concerns are defined as follows:

Union Relations

This indicator measures the severity of controversies related to a firm's union relations practices. Factors affecting this evaluation include, but are not limited to, the firm's response to union organizing efforts and its bargaining practices with existing unionized workers, resistance to improved practices, and criticism by NGOs and/or other third-party observers.

Employee Health & Safety

This indicator measures the severity of controversies related to the safety of a firm's employees. Factors affecting this evaluation include, but are not limited to, a history of involvement in workplace safety-related legal cases, widespread or egregious fines for unsafe workplace practices, resistance to improved practices, and criticism by NGOs and/or other third-party observers.

Supply Chain

This indicator measures the severity of controversies related to a firm's supply chain. Factors affecting this evaluation include, but are not limited to, a history of involvement in supply chain- related legal cases, widespread or egregious instances of abuses of supply chain employee labor rights, supply chain employee safety, resistance to improved practices, and criticism by NGOs and/or other third-party observers.

Child Labor

This indicator measures the severity of child labor controversies in a firm's supply chain. Factors affecting this evaluation include, but are not limited to, a history of involvement in child labor- related legal cases, widespread or egregious instances of child

labor in the firm's supply chain, resistance to improved practices, and criticism by NGOs and/or other third-party observers.

Labor-Management Relations

This indicator captures companies that are involved in employee-related controversies that are not covered by other MSCI ESG Research ratings.

Our data for examining the *Employee Welfare Index* covers approximately 650 corporations from 1994 to 2000, 1,100 corporations from 2001 to 2002, and around 3,000 corporations from 2003 to 2012.

We identify the governance model of a corporation based on whether such a corporation has a staggered board. When a corporation has a staggered board it is less exposed to shareholder pressure, with the result that its directors are likely to have more discretion to deviate from the shareholder primacy norm. On the contrary, when corporate elections are held annually, directors are more exposed to the threat of shareholder removal and, consequently, to shareholder interference. Data on *Staggered Board* (an indicator variable for the presence of a staggered board) are for the period 1978-2011 and obtained from the dataset used in the Cremers-Sepe (2016). Since our main focus is on the value relevance of employee welfare, the main dependent variables in our analysis are profitability and firm value. As a proxy for these variables, we use the return on assets, calculated as the ratio of the firm's EBITDA over the book value of total assets, (*ROA*), and Tobin's Q (*Q*), with all these variables being from Compustat.

Finally, to control for factors that could have an impact on firm value, we always include standard controls using Compustat data.

2. *Results*

Table 1, Column 1 presents our results for the cross-section of firms, including control for both industry and year fixed effects. Column (1) present results for the association between the *Employee Welfare Index* and profitability (i.e., *ROA*). We document that the cross-sectional coefficient on the *Employee Welfare Index* is positive and statistically significant—suggesting that firms granting more welfare to their employees are associated with higher profitability.

However, a cross-sectional analysis will only identify an association between employee welfare and firm performance, without addressing endogeneity concerns. To mitigate these concerns, in Column 2 we perform a time-series analysis. This different empirical methodology allows us to include firm fixed effects and, thereby, to compare average firm profitability before versus after a change in the *Employee Welfare Index*. The time-series analysis in Column 2 confirms the positive and statistically significant association of the *Employee Welfare Index* with firm profitability, suggesting that increasing a firm's employee welfare results in increased firm profitability in the long term.

TABLE 1: PROFITABILITY AND EMPLOYEE WELFARE

Table 1 presents annual pooled panel *Profitability* (i.e., return on assets) regressions on the *Employee Welfare Index* with year dummies and control variables. Column 1 includes industry fixed effects, while Column 2 also includes firm fixed effects. Both Columns include the following control variables: *Ln (Assets)$_{[t-1]}$*, *Delaware Incorporation$_{[t-1]}$*, *ROA$_{[t-1]}$*, *CAPX/Assets$_{[t-1]}$*, *R&D/ Sales$_{[t-1]}$*, and *Industry M&A Volume$_{[t-1]}$*. Statistical significance of the coefficients is indicated at the 1%, 5%, and 10% levels by ***, **, and *, respectively. T-statistics based on robust standard errors clustered by firm are reported in their absolute value between "(.)".

Dep. Variable: *Profitability$_{[t]}$*		
Variables	(1)	(2)
Employee Welfare Index$_{[t-1]}$	0.00826***	0.00301***
	(8.36)	(3.08)
Ln (Assets)$_{[t-1]}$	0.0114***	0.00635**
	(13.12)	(2.41)
Leverage	-0.122***	-0.150***
	(-16.23)	(-14.74)
CAPX/Assets$_{[t-1]}$	0.164***	0.165***
	(6.78)	(6.05)
R&D/ Sales$_{[t-1]}$	-0.560***	-0.425***
	(-29.31)	(-13.40)
R&D Missing	-0.000245	0.00141
	(-0.08)	(0.33)
PPE/Assets$_{[t-1]}$	-0.0307***	-0.125***
	(-2.99)	(-7.85)
Fixed Effects	SIC + Year	Firm + Year
N	24,241	24,337
Adjusted R-Squared	0.392	0.660

In Table 2, we test whether a corporate governance model that provides for more insulation from shareholder interference, as proxied by the adoption of a staggered board, is associated with higher firm in the long term and whether this model is more valuable when a firm has a more intense specific relationship with labor. We measure the existence of a specific relationship with labor through *Labor Productivity*, which identifies industries with a higher marginal product of labor and, hence, more firm-specific investments by the employees.

TABLE 2: FIRM VALUE, STAGGERED BOARDS AND LABOR

Table 2 presents annual pooled panel *Firm Value* regressions on *Staggered Board* with firm and year dummies and the following control variables: *Ln (Assets)*$_{[t-1]}$, *ROA*$_{[t-1]}$, *CAPX/Assets*$_{[t-1]}$, *R&D/ Sales*$_{[t-1]}$, and *Industry M&A Volume*$_{[t-1]}$. In Column 2, we add *Labor Productivity* and its interaction with *Staggered Board*. Statistical significance of the coefficients is indicated at the 1%, 5%, and 10% levels by ***, **, and *, respectively. T-statistics based on robust standard errors clustered by firm are reported in their absolute value between "(.)".

Dep. Variable: *Firm Value*$_{[t]}$		
Variables	(1)	(2)
Staggered Board$_{[t-1]}$	0.0575**	-0.0493
	(2.07)	(-0.91)
Staggered Board$_{[t-1]}$		0.0994***
* *Labor Productivity*		(3.74)
Labor Productivity		-0.227***
		(-8.31)
Ln (Assets)$_{[t-1]}$	-0.220***	-0.274***
	(-12.56)	(-13.41)
ROA$_{[t-1]}$	2.961***	3.105***
	(20.31)	(19.16)
CAPX/Assets$_{[t-1]}$	0.128	0.0555
	(0.75)	(0.26)
R&D/ Sales$_{[t-1]}$	1.425***	0.933*
	(2.68)	(1.70)
Industry M&A Volume$_{[t-1]}$	-0.152***	-0.143**
	(-2.80)	(-2.53)
Fixed Effects	Firm+Year	Firm+Year
N	30,797	24,880
Adjusted R-Squared	0.740	0.748

As shown in Column (1) of Table 2, the association between *Staggered Board* and *Firm Value* is positive, and both strongly statistically and economically significant. This result suggests that a corporate governance model with more board insulation is desirable to enhance long-term firm value. This result is consistent with insights from economic theory suggesting that a shareholder economy does not produce efficient results under the hypothesis of incomplete markets.

We also report that the interaction between *Staggered Board* and *Labor Productivity* (Column (2)) has a positive and both strongly statistically and economically significant coefficient. Economically, the coefficient implies that if a firm is in an industry whose labor productivity is above the average, the adoption of a staggered board is associated with greater increase in firm value. This result suggests that labor, as a

production factor, is more valuable when the corporation gives fewer rights to the shareholders (i.e., the capitalists).

Conclusion

We have argued that fairness is an intuitively important value but we have also argued that under conditions of incomplete markets fairness is a value that is threatened in the context of voluntary exchange. Nevertheless, we observe that markets with such exchange can be very productive. So the question has been how to reconcile the concern for fairness with the productivity of markets. We have articulated a principle of remedy that can be grasped through the democratic analogy. We have argued that in fact under incomplete markets institutions that implement fairness in the corporate form can actually enhance the productivity of the society and so there is a kind of harmony between the values of productivity and fairness.