Corporate Governance, Favoritism and Careers

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Motivation

- "Managing promotions effectively is one of the most powerful ways leaders can drive their company's success" (Rohman et al., Harvard Business Review, 2018).

- But the interests of controlling shareholders may not be aligned with that of other investors: their favorite candidates for promotions may not be the most deserving ones.

- **This paper**
    - Promotion policies trade off **monetary gains** from meritocratic promotions against **private benefits** from favoritism.
    - Corporate **governance** standards affect:
        - the incentive to promote employees based on merit $\rightarrow$ employees' expected **career paths**
        - employees' matching with employers and initial educational choices $\rightarrow$ **skill composition** of the workforce

Main Findings

1. Firms that adopt **meritocratic promotion rules** pay higher wages and feature higher productivity and profitability.

2. Better **corporate governance**, by limiting the extraction of private benefits, raises the fraction of meritocratic firms → in a sorting equilibrium, improves the employment and promotion prospects of high-skill workers.

3. **Labor market competition** ambiguously affects workers' career choices: it raises expected wages, but reduces the share of job openings in meritocratic firms.

4. If workers' **educational choices** are determined endogenously, there are multiple equilibria: those with a greater fraction of meritocratic firms feature greater productivity, wages and profits → efficiency rationale for corporate governance.

Related Literature

- **Normative debate on firms' objective function:**
  - shareholderism (Friedman, 1962; Shleifer & Vishny, 1997);
  - stakeholderism (Tirole, 2001; Magill et al. 2015).

  Our model: no contrast between shareholder value maximization and concern for stakeholder welfare.

- **Corporate governance externalities:** Acharya & Volpin (2010); Dycks (2012); Levit & Malenko (2016).

  Our model: GE interactions between corporate governance, labor market outcomes and firm production decisions.

- **Careers and favoritism:**
  - discrimination (Becker, 1957; Huang et al., 2021);
  - favoritism (Prendergast & Topel, 1996; Friebel & Raith, 2004);
  - competition and talent allocation (Waldman, 1983; Dato et al. 2021; Bar-Isaac & Levy, 2022).
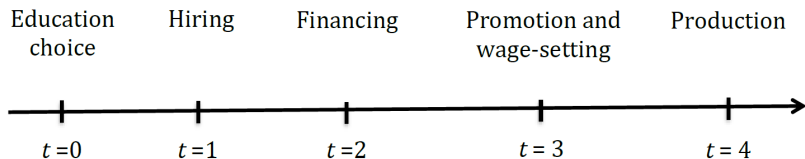
  Our model: role of corporate governance.

The Model

- ▶ Unit mass of firms with 1 unit each. Each unit needs N workers and a capital stock whose cost is standardized to 1.

- ▶ The entrepreneur funds investment out of his wealth $A < 1$ and $1 - A$ via equity issued to competing investors, entitling them to a fraction $1 - \alpha$ of the firm's profits.

- ▶ All players are risk-neutral and feature no discounting.

- ▶ Employees are either assigned to a production task or trained for a managerial one (promotion):
    - ▶ N_L low-skill workers produce $x > 0$ in either task;
    - ▶ N_H high-skill workers produce either $x > 0$ in the production task or $(1 + \Delta)x$ in the managerial one.
    - ▶ In each unit there is one manager and $N - 1$ productive workers.

- ▶ At the hiring stage, only workers know their type. After the hiring stage, types become observable to firms, but are *not verifiable* $\rightarrow$ no commitment to promotions.

The Model ct'd

- The entrepreneur can require promoted workers to generate a firm-specific private benefit B for him, but this prevents high-skill workers from producing Δx.

- The taste for private benefits varies across entrepreneurs: $B \sim U[0, \bar{B}]$.

- The entrepreneur extracts private benefits with probability $1 - g$, where $g \in [0, 1]$ is the quality of corporate governance.

- The total workforce (M) exceeds aggregate labor demand (N), and comprises M_H high-skill and M_L low-skill workers.

Time Line

Education choice	Hiring	Financing	Promotion and wage-setting	Production
$t=0$	$t=1$	$t=2$	$t=3$	$t=4$

Wage Setting

- At $t = 3$, workers get a poaching offer with prob. $p \in (0, 1)$.

- Competing firms observe employees' quality and promotion status in their current firm.

- Equilibrium wages are:

$$w = \begin{cases} p(1 + \Delta)x & \text{for high-skill promoted workers,} \\ px & \text{otherwise.} \end{cases}$$

- The opportunity cost of the private benefit B is $p\Delta x$ larger if produced by a high-skill worker $\rightarrow$ only low-skill workers are asked to generate B.

Promotions

- ► Entrepreneurs decide whether to promote high-skill (meritocracy) or low-skill (favoritism) workers:
    - ► trade-off the expected private benefit $(1-g)B$ against the monetary gain from greater productivity implied by meritocratic promotions $\alpha(1-p)\Delta x$;
    - ► promote according to merit if equity stake is large enough:

$$\alpha \geq \frac{(1-g)B}{(1-p)\Delta x} \equiv \hat{\alpha}, \qquad (1)$$

Assumption

The entrepreneur will never extract private benefits of control if he is the sole owner of the firm:

$$\frac{\bar{B}}{(1-p)\Delta x} \leq 1. \qquad (2)$$

External Financing

- At $t = 2$ the entrepreneur raises $1 - A$ by pledging a share $1 - \alpha$ of the profits to competitive risk-neutral investors.

- Investors' participation constraint:

$$(1 - \alpha)\pi = 1 - A.$$

- Firm's per-dollar profits depend on its promotion rule:

$$\pi = \begin{cases} \pi_H = (N + \Delta)(1 - p)x & \text{with meritocratic promotions,} \\ \pi_L = N(1 - p)x & \text{otherwise.} \end{cases}$$

- We assume that $\pi_L \geq 1$: even firms that do not promote workers based on merit are viable.

Equilibrium Promotions

- The entrepreneur's stake in the firm is determined by investors' participation constraint:

$$\alpha_i^* = 1 - \frac{1-A}{\pi_i}$$

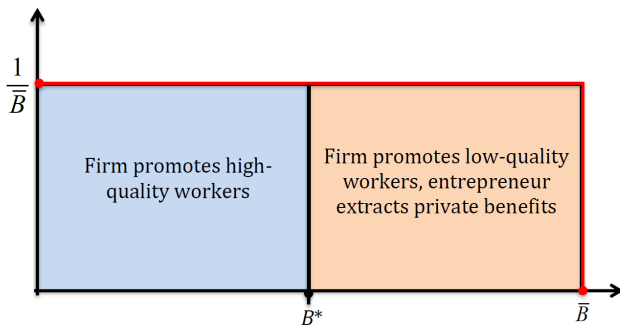- In equilibrium $\alpha_H^* \geq \hat{\alpha} > \alpha_L^*$:

Proposition (Optimal Promotion Rule)

The entrepreneur promotes high-skill workers if $B \leq B^*$ and low-skill workers if $B > B^*$, where

$$B^* \equiv \frac{1}{1-g}\left[\Delta(1-p)x + \frac{\Delta}{N+\Delta}\left(A-1\right)\right] > 0. \qquad (3)$$

- The fraction of meritocratic firms is $q \equiv B^*/\bar{B}$

Firm Distribution

Cross-sectional distribution of private benefits of control (B)

- The fraction of meritocratic firms is $q \equiv B^*/\bar{B}$ is:
  - **increasing** in the quality of corporate governance (g), the incremental productivity of promoted skilled workers (Δx) and the internal equity share (A);
  - **decreasing** in labor market competitiveness (p) and in the maximal potential private benefit ($\bar{B}$).

Workers' Job Selection

- At $t = 1$, workers choose which jobs to apply for, and firms randomly hire from the applicants' pool.

- Workers can distinguish meritocratic firms from non-meritocratic ones.
  - As firms are homogeneous in each group, workers simply choose whether to apply for jobs in one of the two groups.

- Let $m_i = M_i/M$ denote the fraction of job-seekers of type i, and $a_M = A_M/M$ the fraction of applicants for jobs in meritocratic firms.

- Workers who apply for a job but are not hired remain unemployed and earn the reservation (zero) wage.

Sorting Equilibrium

- High-skill workers apply for jobs in meritocratic firms if

$$\underbrace{\frac{q}{\hat{a}_M}}_{\text{Pr(hire}|M)} \left[\underbrace{\frac{1}{N_H}(1+\Delta)px}_{\mathbb{E}(w|\text{promotion})} + \underbrace{\left(1 - \frac{1}{N_H}\right)px}_{\mathbb{E}(w|\text{no prom.})} \right] > \frac{1-q}{1-\hat{a}_M}px,$$

- Low-skill workers apply for jobs in non-meritocratic firms if

$$\frac{1-q}{1-\hat{a}_M}px > \frac{q}{\hat{a}_M}px,$$

Proposition (Labor Market Sorting)

High-skill and low-skill workers respectively apply for jobs in meritocratic and non-meritocratic firms if $\theta m_H < q < m_H$ where $\theta \equiv \frac{N}{(1-m_H)\Delta + N} \leq 1$. In equilibrium $a_M^* = m_H$ and $1 - a_M^* = m_L$.

Corner Equilibria

- If $q \leq \theta m_H$ both high-skill and low-skill workers apply for jobs in non-meritocratic firms.
  - The only rational belief is $\hat{a}_M = 0$.
  - Meritocratic firms are unable to operate: in equilibrium $\hat{q} = 0$, where $\hat{q}$ denotes the fraction of *active* meritocratic firms.

- If $q \geq m_H$, both high-skill and low-skill workers apply for jobs in these firms.
  - In this scenario, all workers will apply for jobs in meritocratic firms, so that $\hat{a}_M = 1$, and $\hat{q} = 1$.

Endogenous Skill Acquisition

- We now endogenize the skill composition of the workforce through workers' educational choice at $t = 0$:
  - workers are of low quality unless educated at cost $\psi > 0$;
  - investment in education is socially efficient.

- Two-way relationship between educational choices and fraction of meritocratic firms $\rightarrow$ multiple equilibria.

Multiple Equilibria

- Feedback loop:
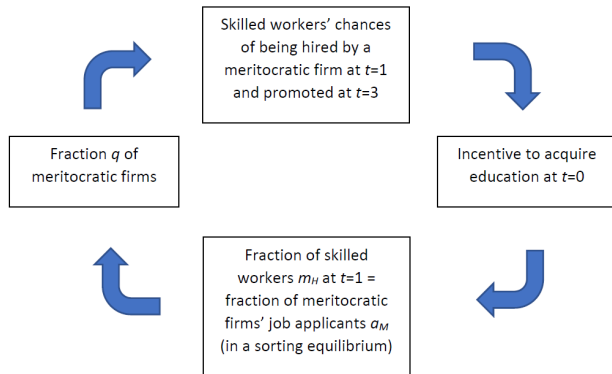
- Three equilibria with different fractions $\hat{a}_M$ of workers are expected to apply for jobs in meritocratic firms:
    1. equilibrium where $\hat{a}_M = 0 \rightarrow$ these firms inactive $\rightarrow m_H^* = 0$;
    2. intermediate equilibrium where $\hat{a}_M$ is such that $q \in (\theta \hat{a}_M, \hat{a}_M)$;
    3. equilibrium where $\hat{a}_M = 1 \rightarrow$ only these firms active$\rightarrow m_H^* = 1$.

Intermediate Equilibrium

▶ Let us characterize workers' educational choice and the resulting m_H^* in the intermediate equilibrium where workers sort across firms when searching for jobs.

Proposition

In the intermediate equilibrium, the fraction m_H^* of skilled workers is uniquely defined by the indifference condition balancing the expected benefit of education with its cost:

$$\frac{NI}{M}\left[\frac{q}{m_H^*}\frac{\Delta + N}{N} - \frac{1-q}{1-m_H^*}\right]px = \psi. \tag{4}$$

The equilibrium fraction m_H^* is increasing in the quality of corporate governance, g. An increase in labor market competition p has an ambiguous effect on m_H^*: this is increasing in p for $p < p^*$ and decreasing for $p \geq p^*$, where $p^* \in (0, 1/2)$.

Intermediate Equilibrium ct'd

- Better corporate governance increases the fraction of meritocratic firms → raises workers' incentive to acquire education; it also increases social welfare.

- The effect of labor market competition on educational choices is ambiguous: it raises
  1. workers' bargaining power → expected wage upon promotion;
  2. the retention cost of high-skill workers → discourages firms from promoting skilled workers.

- If the labor market is not too competitive ($p \leq p^*$), the first effect prevails.

- If instead $p > p^*$, the second effect dominates: an increase in labor market competition will reduce the fraction m_H^* of skilled workers.

A Graphical Example
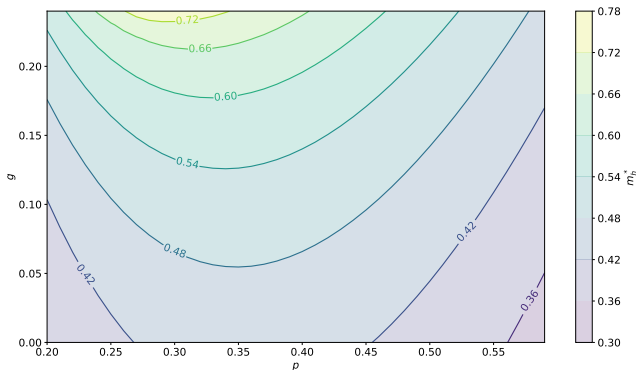
- ▶ Vertical axis: corporate governance quality (g).
- ▶ Horizontal axis: labor market competition (p).
- ▶ Shading: fraction of skilled workers (m_H^*: right-hand scale).

Corner Equilibria

Proposition

The economy features two corner equilibria:
1) *one where $\hat{a}_M = 0$ and no worker acquires education: $m_H^* = 0$;*
2) *one where $\hat{a}_M = 1$ and all workers acquire education: $m_H^* = 1$.*

▶ If no one is expected to apply for jobs in meritocratic firms, these firms are expected to be inactive, being unable to attract the necessary workforce $\rightarrow$ optimal not to acquire education.

▶ The opposite applies if everyone is expected to apply for jobs in meritocratic firms.

▶ The equilibria are Pareto-ranked: a higher share of skilled workers and meritocratic firms are associated with higher expected social surplus.

Conclusions

- ▶ Workers' careers may be shaped by favoritism and discrimination if the objectives of controlling shareholders are misaligned with those of external financiers.

- ▶ **Corporate governance standards:**
  - ▶ improve the share of meritocratic companies, hence the skill composition of the workforce and aggregate productivity and average wages.

- ▶ **Labor market competition** has an ambiguous effect:
  - ▶ it raises wages upon promotion and thus workers' incentive to acquire skills;
  - ▶ but it also increases retention costs, thus reducing the share of meritocratic firms.

- ▶ **Endogenous skill acquisition** $\Rightarrow$ multiple equilibria: fraction of meritocratic firms positively correlated with that of skilled workers across equilibria.