Organized labor and information asymmetry in the financial markets

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Abstract

Prior results from the labor relations literature suggest that revealing information weakens management's position in collective bargaining. Thus, when facing organized labor, management has an incentive to preserve the information asymmetry with outsiders. This study uses a sample from a large cross-section of the economy over several years to test this relation. Results are consistent with this prediction. Strong organized labor is associated with higher bid-ask spreads, higher probability of informed trading, lower trading volume and lower analyst coverage. These relations hold after controlling for numerous factors such as growth opportunities or risk.

Notes

1. For example, disclosure is expected to increase liquidity (e.g., Diamond & Verrecchia, 1991; Kim & Verrecchia, 1994), to reduce the cost of capital (e.g., Barry & Brown, 1984, 1985, 1986), or to increase information intermediation (e.g., Bhushan, 1989a, b; Diamond, 1985; Lang & Lundholm, 1993).

2. See Healy and Palepu (2001) for a review.

3. See, for example, Akerlof (1970) or Grossman (1981).

4. See Healy and Wahlen (1999) for a review. Reasons for managing earnings upwards may include issuing stocks or making stock-based acquisitions, meeting analysts' forecasts or catering to a particular clientele of investors. The literature also contains rarer examples of management using accounting choices to lower reporting earnings: managers who want to shift earnings to the following period since they were unable to reach their target in the current period (Healy, 1985), firms with high political costs (Watts & Zimmerman, 1986), before a management buy-out (Perry & Williams, 1994) or before a stock plan repurchase (Aboody & Kasznik, 2000).

5. See Liberty and Zimmerman (1986) for a discussion of the incentives to decrease income on average.

6. This is particularly true since Katz (1993) reports a tendency in North America toward decentralized bargaining instead of centralized negotiations in the firm. This decentralization adds complexity to the negotiation process. Frost (2000) empirically describes the importance of information for labor in decentralized negotiations.

7. In this setting, uncertainty means the distribution of incentives is known but not the period-specific realizations.

8. Other examples using the uncertainty of objectives include Alesina and Cukierman (1990) and Eijffinger, Hoeberichts, and Schaling (2000).

9. They use their model in the context of a government biasing reporting about money creation instead of a manger biasing reporting about economic value creation. I have substituted manager for government in the description of their model.

10. Cukierman and Meltzer (1986) also show the average bias will be higher when the manager has more incentive to over-report. This is generally consistent with the empirical literature (e.g., Bowen et al., 1995; Cullinan & Knoblett, 1994; D'Souza et al., 2001).

11. *Ex ante* here means before the period-specific incentives are known.

12. In their setting, this occurs when the distribution of incentives to over-report has a lower average or a higher variance.

13. Consistent with this idea, Graham, Harvey, and Rajgopal (2005) provide survey evidence indicating that managers try to avoid setting a disclosure precedent that will be difficult to maintain.

14. Van Ness, Van Ness, and Warr (2001) report that there is no statistical relation between either analyst forecast errors or dispersion and the information component of the spreads (estimated using five different models). In addition, only considering firms for which a meaningful consensus or dispersion exists would require focusing on larger and better covered firms (e.g., firms with more than four analysts) where the effect is expected to be smaller.

15. The TAQ database starts in 1993. However, unionization data are available only after 1995.

16. To increase the integrity of the data, I only keep "good" and "regular" trades (as defined by TAQ). In particular, corrected trades (TAQ item CORR greater than 0) or conditional trades (TAQ item COND equal to A,B,C,D,G,J,N,O,R,S,T,W,X,Z,8 or 9) are deleted. Similarly, opening quotes (TAQ item MODE greater than 12) are removed.

17. Firms where CRSP item ZLIST is different from 1, 3, 4, 5, 15, 17, 21, 23 or 25 are excluded.

18. Securities where CRSP item SHRCD is different from 10 or 11 are excluded.

19. Another point raised by Callahan et al. (1997) is that there is a small dispersion across spreads. This would reduce the power of the test but should not bias the results. In other words, a small dispersion is likely to understate the magnitude of the effect. However, results in Table 2 panel C suggest that there is some variation in spreads, at least when the entire distribution of firms is considered, and not only the largest ones.

20. Since the details on the estimation of the model are fairly complex, the interested reader is referred to the original studies by Easley et al. (1997, 2002) for more technical details.

21. www.smith.umd.edu/faculty/hvidkjaer/data.htm

22. Results still hold in a sub-sample of firms with at least one analyst.

23. See Freeman and Medoff (1979), Salinger (1984), Bronars and Deere (1991) for examples of using industry-level unionization data and financial data.

24. Volume is double counted in the TAQ database for NASDAQ stocks. Therefore, following Krische and Lee (2000), I divide volume by 2 for stocks listed on the NASDAQ.

25. In addition, the effect on other variables such as the cost of capital is not considered in this study. The total effects are therefore likely to be greater than just the effect on spreads and analysts evidenced in Sect. 4.

26. Rosett (2001) reports that firms with high labor intensity and unionization experience higher return volatilities and higher market betas. The difference between the results may possibly be explained by a difference in the sample. Rosett's study has 687 observations from highly unionized and fairly large firms. This sample contains about 10,000 observations and covers both low-unionized and highly unionized firms.

27. As in Rock et al. (2000), the sign and the significance of some of the control variables are affected if we use a count-data estimation technique.

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