Do institutional investors mitigate social costs of privatization?
Evidence from prisons
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Federal Reserve Board¹

Political Economy of Finance Conference 2020

¹The views expressed are solely the author’s and do not reflect the views of the Board of Governors or the Federal Reserve System
Institutional ownership and firm performance

An extensive literature shows that institutional ownership changes shareholder behavior:

▶ Seems to give investors more long-term view on profits
  
  ▶ Aghion, van Reenen, Zingales (2003): institutional ownership leads to increase in firms' innovation by shielding managers from career risks
  
  ▶ Institutional ownership leads to improvements in ESG metrics (Chen, Dong, Lin (2020), Krueger, Sautner, Starks (2020), Starks, Venkat, Zhu (2017))
  
  ▶ This effect is stronger in longer term horizon, and driven by ESG-related proposal which are business-related

▶ However, little direct evidence if this leads to greater shareholder profits, or should be instead thought of as consumption good (i.e. maximizing shareholder well-being, not profits (Hart and Zingales (2017))

This paper: Does increase in institutional ownership has positive effects for government contracts?
Summary of Findings

Setting: US private prisons, whose institutional ownership increased from 2% to 22%

1. Privatization negative externalities: Private prisons have higher suicide rates
   - Prisons have 5x higher rates (0.1%) than national suicide average (0.02%)
   - Private prisons’ rate: 2x higher than public prisons

2. 1% increase in institutional investors reduces prisoner suicides by 1.2%
   - Results are driven by institutional investors with long-term horizons
   - Result is stronger in more litigious states and more long-term investors
   - Instrumenting for institutional ownership with exogenous law change which increased

⇒ Institutional investors mitigate social costs of privatization
Main Contributions

▶ EXTREMELY extensive data collection on private prisons using FOIAs
  ▶ The most extensive data set on private prisons to date
  ▶ As a result, we can compare public and private prisons among multiple outcomes
  ▶ Finally an answer to the question on whether private and public prisons have different recidivism levels (yes)

▶ The first paper to measure the effect of institutional ownership on privatized public service companies

▶ Adds context to a very socially important (but under-researched) topic, given the problems of mass incarceration
1. Here: institutional ownership↑⇒ quality↑. What happens to costs?
   - If we only cared about quality, why privatize prisons in the first place?
   - If the higher quality leads to higher costs (likely), who pays: the tax payer or the shareholders?

2. While institutional ownership shrinks the quality gap between public and private prisons, it doesn’t close it
   - The big question: are prisons are a good candidate for privatisation at all?
The Substitution between Costs and Quality

The model of Hart, Shleifer, Vishny and Hart, (1997) predicts a trade-off between quality and costs.

- In 2004, the agency overseeing FL private prisons changed, after a corruption scandal.
- As a result the monitoring increased.
Who pays for the better private prison quality?

➤ The taxpayer?
  ➤ (As much as it is observable): do we see increase in the per diem cost in firms with higher institutional ownership?
  ➤ Did the selection of prisoners change?
  ➤ A quicker statistics: aggregate state-level expenditures in public vs private prisons

➤ The shareholders?
  ➤ The results on litigation are promising, but even better to provide direct evidence
  ➤ Do firms' stocks do better after increase in institutional ownership?
    ➤ The private prisons market: dominated by two publicly traded firms and several non-publicly traded ones
    ➤ Be more explicit about the firm-level variation in your analysis!
  ➤ If it is about long-term profitability, does the probability for losing a contract after suicides spiking increase?

Very different public policy implications!
Costs of privatization for taxpayer

How costly are suicides compared to other outcomes to the public?

Recidivism:

- Pr(recidivism) = 0.24 in public and 0.28 in private prisons (Table 2)
- The average length of a sentence: 15 years (Table 1)
- Average daily cost of prisoner per night: $50
- ⇒ Having a prisoner in private prison increases the costs to taxpayers by $0.04 \times $50 \times 365 \times 15y = $11,000 due to recidivism

Suicide:

- Pr(recidivism) = 0.002 in public and 0.001 in private prisons (Table 2)
- Largest suicide prison settlement in CA: $8.3 million settlement
- ⇒ Upper bound on having prisoner in a private prison: $8,300

2FL: [http://edr.state.fl.us/content/conferences/criminaljusticeimpact/2019DOCPerDiemandBedCosts.pdf](http://edr.state.fl.us/content/conferences/criminaljusticeimpact/2019DOCPerDiemandBedCosts.pdf)
Bigger implications of the findings... why privatize prisons?

Are prisons a good candidate for privatisation?

- (HSV 1997): private prison contract is incomplete (quality is non-contractible), privatization leads to quality↓ and cost↓.
- This paper, using a very comprehensive data set, shows that quality decreases in private prisons among multiple dimensions (even accounting for institutional ownership)
  - Several papers confirm that quality decreases in private prisons
- In the literature, there is little evidence for cost-saving
  - Hard to compare: lack of data on cost per prisoner, and potential issues with private prisons selecting the cheapest prisoners to work with
  - (Therefore my first point on asking about costs)

⇒ If comparing cost is so hard and the government is not able to provide evidence that costs go down, perhaps both quality↓ AND taxpayer costs↑, prisons are bad public policy.
Overall...

- Interesting paper, utilizing an unique data set to shed light on a relatively understudied aspect of public finance

- Promising results on showing the effects of institutional ownership on government contracting