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

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## Big picture

- **What is the human cost of privatizing government services?**
  - Privatizing prisons (immigration detention centers) has increased by 47% (442%) from 2000 to 2016
  - Private enterprises may *solely* maximize profit by neglecting to internalize negative consequences, leading to a rise in social costs

- **What is the role of institutional investors when such social trade-offs arise?**
  - Institutional ownership in prison stocks has risen by over 60%
  - Do institutional investors *only* care about portfolio returns?
BlackRock-owned Mexican prison

Source: Permell PM
Institutional investors and prison management companies

- Vanguard: 15.82%
- BlackRock: 11.79%
- State Street: 3.31%
Legislative action

California bans private prisons and immigration detention centers

New York Could Become First State To Be Completely Done With Private Prisons

Elizabeth Warren says she would ban private prisons and detention facilities as president
This paper

- Empirically analyzes whether a social trade-off arises when prison services are outsourced to private enterprises
  - Hart, Shleifer, and Vishny (1997), for example, theoretically predict that privatization of prisons may lead to negative effects when contracts are incomplete.
This paper

- Empirically analyzes whether a social trade-off arises when prison services are outsourced to private enterprises
  - Hart, Shleifer, and Vishny (1997), for example, theoretically predict that privatization of prisons may lead to negative effects when contracts are incomplete

- Examines whether institutional investors of public companies that manage prisons mitigate such social costs
  - Hart and Zingales (2017) state that shareholders may “take social factors into account and internalize externalities”, which may include social costs
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- Studies what types of institutional investors are more attentive to corporate social responsibility outcomes

- Examines why institutional investors have an incentive to internalize social costs
Main findings

- Privatization of prisons is associated with a rise, by up to 39%, in the number of suicides. Institutional investors partially offset this effect. A 1% increase in institutional ownership reduces suicides by 1.2%
- Suicide rates are non-contractible, but probability of committing suicide declines when prisons are managed more ethically (Cramer et al., 2017; Fazel et al., 2017)
- The results are robust to using alternative social outcomes
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- Using a new identification strategy, I find that passive ownership effects on social outcomes are causal

- Litigation and reputation risks give an incentive to institutional investors to internalize social externalities
Contribution

- **Trade-off of privatization**: Hart, Shleifer, and Vishny (1997)
  - In a world with incomplete contracts where residual control rights matter, firms may sacrifice quality that negatively impacts prisoner lives
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- **Shareholder preferences matter**: Hart and Zingales (2017)
  - Firms may not solely maximize profits, but incorporate negative social externalities when making managerial decisions
Contribution

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- **Shareholder preferences matter**: Hart and Zingales (2017)
  - Firms may not solely maximize profits, but incorporate negative social externalities when making managerial decisions

- **Main contribution**: Examine whether social cost of privatization is mitigated by institutional ownership
Prison-level data

- Filed 51 state-specific *Freedom of Information Act* requests (includes D.C.)
- Followed-up every 2 weeks until the data was provided
  - Total 839 emails were exchanged; made over 20 calls; sent over 10 fax messages
- Contacted over 10 lawyers and 30 advocacy groups for states that caused significant delays
- Filed complains with commissioners, governors, and members of congress
- Hand-collected data to construct 26 time-varying variables from over a thousand official reports
- Sample period: 2000 – 2018
Other data

- **Institutional ownership data:** Thomson Reuters (S34), WRDS SEC Analytics, and SEC Edgar
  - Obtain missing holdings and aggregate holdings to parent level following Ben-David, Franzoni, Moussawi, and Sedunov (2018) and Lewellen and Lewellen (2018).

- **ETF ownership data:** CRSP, Thomson Reuters (S12), ETF Global
  - Define ETF ownership following Ben-David, Franzoni, and Moussawi (2018)

- **Litigation data:** U.S. Chamber Institute for Legal Reform; PACER
Overview

1. Test whether privatization is associated with higher inmate suicides
2. Examine whether ownership matters when social costs of privatization arise
3. Analyze whether the type of institutional investor matters
4. Using a new identification strategy, I examine the causal relationship
5. Examine why institutional investor may have an incentive to internalize negative social externalities
Is there a human cost of privatization?

- Examine whether there is a relationship between privatization and inmate suicides
- Estimate the following fixed effects regression:

\[
\log(1 + \text{Suicides}_{i,t}) = \beta_0 + \beta_1 \mathbb{1}(\text{Private Prison}_{i,t}) + \beta_v X_{i,t} + \beta_w X_i + \alpha_t + \gamma_s + \epsilon_{i,t}
\]
Inmate suicides as a function of prison privatization

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<tr>
<td>$1(\text{Private Prison}_{i,t})$</td>
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<td>0.304***</td>
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Control Variables: X X X

Fixed Effects:
- Year: X X X X X
- State: X
- Year × State: X
- Prison: X

Observations: 16,175 16,158 16,059 15,041 15,041 14,941
R-squared: 0.144 0.193 0.353 0.172 0.205 0.358

Take away: Prison privatization is associated with higher suicides
Does the ownership structure of the private enterprise matter?

- First, examine whether the negative social cost of privatization is mitigated by total institutional ownership.
- Second, examine whether the effects vary by active versus passive institutional investors.
- Third, examine whether the effects vary by granular investor types.
- Estimate the following fixed effects regression:

\[
\log(1 + Suicides_{i,t}) = \beta_0 + \beta_1 \mathbb{1}(Private\ Prison_{i,t}) + \beta_k Ownership\ Variable(s)_{i,t} + \beta_v X_{i,t} + \beta_w X_i + \alpha_t + \gamma_s + \epsilon_{i,t}
\]
Inmate suicides as a function of institutional ownership

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<tbody>
<tr>
<td>Institutional Ownership$_{i,t}$</td>
<td>$-0.011^{***}$</td>
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<tr>
<td>1(Private Prison$_{i,t}$)</td>
<td>$0.331^{***}$</td>
<td>$0.330^{***}$</td>
<td>$0.363^{***}$</td>
<td>$0.355^{***}$</td>
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<td>16,059</td>
<td>15,041</td>
<td>15,041</td>
<td>14,941</td>
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<tr>
<td>R-squared</td>
<td>0.155</td>
<td>0.203</td>
<td>0.357</td>
<td>0.182</td>
<td>0.219</td>
<td>0.379</td>
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**Take away:** Institutional ownership offsets social cost of privatization
Suicides as a function of passive versus active ownership

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<tbody>
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<td>Passive Inst. Owner.</td>
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<td>-0.027***</td>
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<td>-0.027***</td>
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<td>(0.003)</td>
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<tr>
<td>Active Inst. Owner.</td>
<td>0.012***</td>
<td>0.011***</td>
<td>0.015***</td>
<td>0.011***</td>
<td>0.011***</td>
<td>0.014***</td>
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<tr>
<td><strong>(Private Prison)</strong></td>
<td>0.320***</td>
<td>0.320***</td>
<td>0.377***</td>
<td>0.343***</td>
<td>0.346***</td>
<td>0.385***</td>
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<td>(0.017)</td>
<td>(0.017)</td>
<td>(0.027)</td>
<td>(0.018)</td>
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</tbody>
</table>

Control Variables: X X X

Fixed Effects:
- Year X
- State X
- Year × State X
- Prison X

Observations: 16,175 16,158 16,059 15,041 15,041 14,941
R-squared: 0.157 0.204 0.372 0.183 0.232 0.367

Take away: Passive investors drive the ownership effects
Robustness Checks

- **Alternative mortality rates**: Unexpected deaths, total deaths, mortality rates scaled by total population

- **Rehabilitation programs**: Suicide prevention programs, total programs offered in prison

- **Employment related outcomes**: Total number of correctional officers hired per inmate

- Lagged institutional ownership variables

- **Alternative empirical models**
  - For example: Negative binomial regressions, standard Poisson model, zero-inflated Poisson model

- **Wild bootstrapping method**
Identification strategy

- Endogeneity is a problem (e.g., self-selection of institutional investors)
- Identified a tax reform that is likely to be useful to overcome endogeneity concerns
- IRS reclassified public companies that manage prisons (PMCs) as Real Estate Investment Trusts (REIT) at the end of 2012
- Following the reclassification, public prison management companies entered into new ETFs that track the real estate sector
- This reclassification led to a large increase in ETF ownership levels
- Exclusion restriction: Tax reform was solely driven by the fact that PMCs met the legal definition to be classified as a REIT company
ETF ownership around REIT reclassification

![Graph showing ETF ownership around REIT reclassification]
Instrumental variable approach

- Instrument ETF ownership levels by treatment

- **Treated Group:** Prisons that had at least a non-zero ETF ownership level *prior* to the REIT reclassification

- Estimate the following first stage regression:

$$ETF\ Own_{i,t} = \beta_0 + \beta_1 1(Treated_i) \times 1(Post_t) + \beta_2 1(Treated_i)$$

$$+ \beta_3 1(Post_t) + \beta_4 1(Private_{i,t}) + \beta_v X_{i,t} + \alpha FE + \epsilon_{i,t}$$

- Estimate the following second stage regression:

$$\log(1 + Suicides_{i,t}) = \beta_0 + \beta_1 \hat{ETF\ Own}_{i,t} + \beta_2 1(Treated_i)$$

$$+ \beta_3 1(Post_t) + \beta_4 1(Private_{i,t}) + \beta_v X_{i,t} + \alpha FE + \epsilon_{i,t}$$
## Second stage results

<table>
<thead>
<tr>
<th>ETF Ownership_{i,t}</th>
<th>(I)</th>
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<td>-0.073***</td>
<td>-0.075***</td>
<td>-0.077***</td>
<td>-0.072***</td>
<td>-0.073***</td>
<td>-0.081***</td>
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<td>(0.005)</td>
<td>(0.006)</td>
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<td>(0.005)</td>
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<tr>
<td>\text{1}(Post_{t})</td>
<td>0.030***</td>
<td>0.025**</td>
<td>0.016***</td>
<td>0.024***</td>
<td>0.011*</td>
<td>-0.004</td>
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<td>(0.006)</td>
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<td>\text{1}(Treated_{i})</td>
<td>0.467***</td>
<td>0.465***</td>
<td>0.466***</td>
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<td>\text{1}(Private Prison}_{i,t}</td>
<td>0.386***</td>
<td>0.353***</td>
<td>0.533***</td>
<td>0.413***</td>
<td>0.382***</td>
<td>0.548***</td>
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<td>(0.014)</td>
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**Control Variables**: X X X

**Fixed Effects**

- Year: X X X X
- State: X X
- Year \times State: X X
- Prison: X X

**First Stage F-Statistics**: 63.11 61.33 58.33 56.01 50.93 53.77

**Take away**: Passive ownership leads to a reduction in suicides
Litigation and reputation risk

- **Arena and Julio (2015):** Litigation environment plays an important role for decisions made by shareholders and firms.

- **Colonnello and Herpfer (2019):** Use the U.S. Chamber Institute for Legal Reform Ranking of state litigation plaintiff friendliness as a proxy for litigation risk.

- Examine whether institutional investors are more attentive to social outcome in prisons that are located in plaintiff friendlier states.
## Litigation risk and ownership effects

<table>
<thead>
<tr>
<th>ETF Ownership_{i,t} \times 1(1 \leq \text{Lit. Rank}_{s,t-1} \leq 10)</th>
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</table>

<table>
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<th>1(Private_{i,t})</th>
<th>(I)</th>
<th>(II)</th>
<th>(III)</th>
<th>(IV)</th>
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<tr>
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<td>0.287***</td>
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<td>0.305***</td>
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<tr>
<td></td>
<td>(0.046)</td>
<td>(0.048)</td>
<td>(0.051)</td>
<td>(0.053)</td>
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</table>
Conclusion

- There is a *social trade-off* that arises when prisons are privatized.
- Institutional ownership offsets such social costs.
- Investors with a long investment horizon are more attentive to corporate social responsibility (CSR) outcomes.
  - In particular, institutional investors sensitive to long-term firm value drive the positive social outcomes (e.g., passive investment advisors and companies).
- Investor types *matter* when examining the role of institutional investors in CSR outcomes.
- Institutional investors have an incentive to be socially responsible due to litigation and reputation costs.