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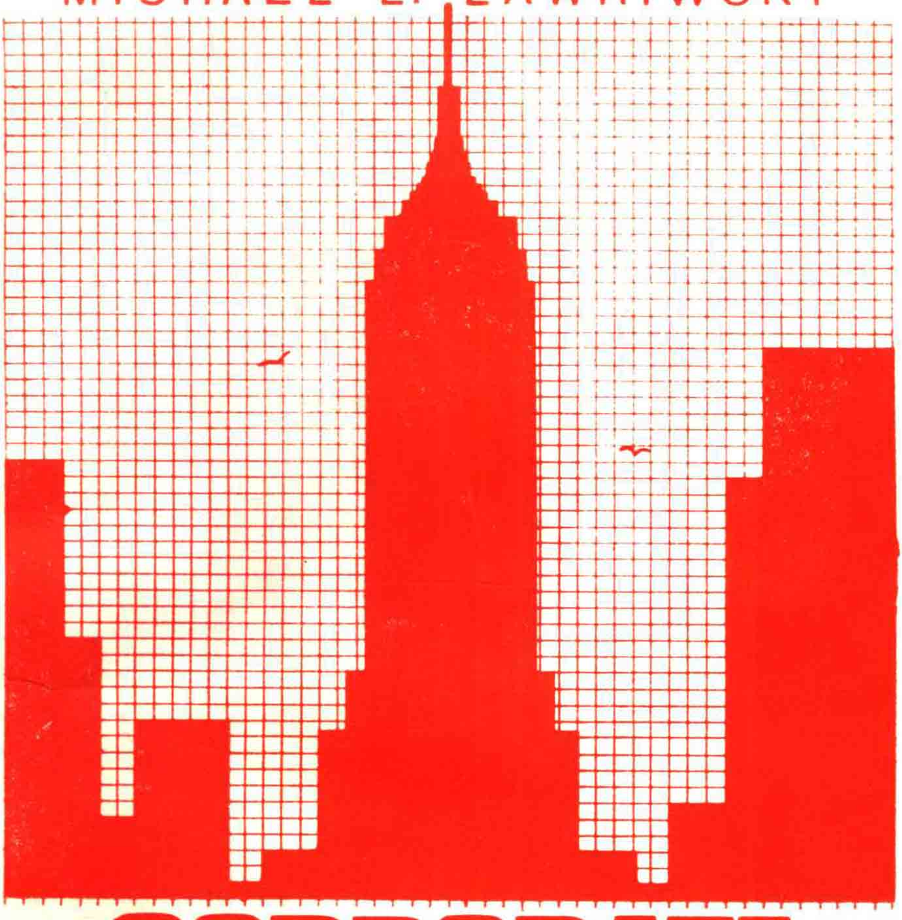

CORPORATE STRUCTURE & PERFORMANCE

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The Role of Owners, Managers and Markets

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PREFACE

The behavioural and performance consequences of the separation of ownership and control have been widely recognised as having the potential to revolutionise the theory of the firm, as well as the current approach adopted in studies of industrial organisation. That such a separation exists throughout Western capitalist economies is indisputable; its progress has been traced in a number of published works. Whether it is of real consequence to theoreticians or policy makers has, by contrast, been a flashpoint of contention. Here empirical researchers over the last 25 years have been content to replicate again and again studies which have sought to test for performance differences between 'owner-' and 'management-controlled' corporations. Using different samples and methods of measurement, a set of conflicting findings has emerged. As a result, the profession has made little progress towards reaching a consensus on this issue. In the meantime the last few decades have witnessed developments which threaten to alter the basic parameters of the separation thesis. Here I am referring specifically to such factors as the exit of small private shareholders and the concomitant growth of financial institutions which has resulted in a trend back to concentrated ownership.

This book makes two contributions to the literature; one theoretical, the other methodological. At the theoretical level it is argued that it is not control type *per se* which is critical in determining the performance of the firm. Instead it is proposed that the prime determinants of observed performance are the interrelationships between internal organisational structure, the product market and the capital market. However, these interactions will be modified by control type, firm size and maturity. Thus, interest is directed at decisions taken at the firm level by top management in response to their incentive structure and internal and external constraints on their behaviour. The major methodological innovation of this study is that it explores the interactions between stockholders, managers and markets. That is, it first examines the ways in which these factors influence behaviour and performance *within* control types before comparisons *between* control types are attempted. It is argued that only in this way may differences (or lack of differences) in performance be fully understood.

The book is based on my doctoral dissertation, which was submitted to the University of Adelaide in 1980. While structured around an empirical study employing Australian data, the theoretical basis of the book is a discussion of the modern corporation, and some emphasis is given to the remarkable similarities in developments taking place in other Anglo-American economies as well as continental European economies.

I owe an eternal debt to David K. Round, my thesis supervisor, for his continual encouragement and incisive comments on successive drafts of the original thesis. It was in my formative years as an undergraduate at the University of Adelaide that David Round, who was then pioneering the empirical application of the structure-conduct-performance triad in Australia, stimulated a keen interest in that field. I am also indebted to Drs John Hatch and Ian McLean for the advice they gave as co-supervisors and to Professors G.C. Harcourt, D.R. Kamerschen, D.C. Mueller, E.A. Russell, Z.A. Silberston and E.L. Wheelwright and Mr R.R. Hirst for the encouragement and comment they provided. I would also like to express my gratitude to Professor F.G. Davidson, who pointed out a number of shortcomings in the expression, presentation or logical progression of the penultimate draft of this book. My most fundamental intellectual debt, though, is to Brother Michael Flaherty, who taught me the love of learning.

The ownership and control data upon which this work is based are among the most comprehensive ever to be compiled in Australia. The task of gathering and collating this data set was one of considerable proportions, involving several inter-state visits. Here thanks are due to the staffs of the corporations, chartered accounting firms and corporate affairs offices in each state for the assistance they provided while searches of publicly available records were made. In particular, I would like to acknowledge the work of Judith Herman, my research assistant, who read and arranged thousands of microfilmed records and made most of the tedious calculations. I am grateful to the Department of Economics at the University of Adelaide for providing funds for this assistance.

Invaluable computing assistance was provided by Michael Petty of the University of Adelaide and Terry Tremayne of La Trobe University. Thanks are also due to Julia Anderson, Sandra Barnes, Helen Cook and Heather Watkins of the School of Economics at La

Trobe University for typing the manuscript.

Finally, I would like to express special thanks to my wife, Maria, who not only accepted my periods of absence from the hearth, but also actively assisted at various stages.

Note on Terminology

In Britain the owners of corporate equity capital are referred to as shareholders. In the United States they are called stockholders. Elsewhere, these terms appear to be used interchangeably and no particular convention is adopted in this book.

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1 INTRODUCTION

The Issues

> firms are not, regardless of what economic theory may suppose, undifferentiated, profit maximizing agencies which react to given market situations in ways which are independent of their organization ... management ... is influenced not only by market pressures, but also by considerations internal to the firm
>
> (E.S. Mason, 1939)

The above quotation, from a paper delivered by Mason at a conference of the American Economic Association (AEA) in 1938, indicates that the pioneer of the market structure-conduct-performance paradigm recognised the importance of the missing corporate structure-performance link. However, the seminal works of Mason (1939, 1949) and Bain (1951, 1956) were unable to incorporate this linkage since the structure-conduct-performance triad was primarily geared to analysis at the market level. It also failed adequately to integrate the vital stock market influences which interact with 'internal considerations' to bring about the allocation of resources which they sought to explain.

In a more recent symposium of the AEA, two of the three papers considering the state of research in industrial organisation (Grabowski and Mueller, 1970; Grether, 1970) independently arrived at the conclusion that future research should, within the context of large, diversified corporations operating oligopolistic markets, become more aware of 'internal organizations, policies and strategies' (p. 85) as essential to gaining an improved understanding of corporate performance. In addition, Grabowski and Mueller sounded a note of caution with regard to the role of econometrics in the study of industrial organisation. That is, unless a suitable way of analysing firms according to their internal structure can be found, empiricists may be forced to abandon econometric techniques in favour of the older case-by-case approach, where the unit of analysis would be the large diversified firm. This is because the cross-sectional studies which have characterised empirical research in the field make the implicit assumption that all firms in a sample react to external shocks on the basis of similar behavioural parameters.

The phenomenon referred to as the 'separation of ownership from control' has occupied a central position in economists' perceptions of factors internal to the firm since the publication of Berle and Means's (1932) *The Modern Corporation and Private Property* a half-century ago.[1] The central thesis of their book was that, owing to the rise of the joint stock corporation, over a number of years the gradual diffusion and dispersion of stockholders would eventually result in a situation where professional managers come to dominate the affairs of the corporation. As an indication of the importance of these developments, Berle and Means estimated that in 1929 up to 44 per cent of the 200 largest corporations in the United States were subject to management control. The secular trend to greater dispersion of shareholdings has, since that time, been documented in many capitalist economies.

But such a trend would not be of very much interest to economists, apart from any associated redistributions of wealth, if there were no behavioural or performance consequences. In the period after the Second World War several alternative theories of the firm emerged in response to the observation that the traditional dual entrepreneurial functions of ownership and management had become separated. In most of these models professional managers were seen to derive utility from the size of the corporation, due to the salary, power and prestige afforded by size. Hence, managers were assumed to be striving to maximise the rate of growth of the firm subject to some minimum profitability or valuation constraint which would satisfy shareholders and provide the desired degree of security from take-over (e.g. Baumol, 1959; Marris, 1964). Other theorists speculated that when market constraints are absent, managers may allow costs to rise (Leibenstein, 1966), or seek discretionary expenditures on staff and emoluments (Williamson, 1964).

The alternative theories of the firm were criticised by orthodox economists (e.g. Baldwin, 1964; Solow, 1968) who argued that there remain significant market restraints on managerial behaviour. Managers must seek profits and win customers and capital in order to survive in the long run. On the other hand, economists of more 'radical' persuasion (e.g. C. Wright-Mills, 1972) have argued that the profit motive of old is still prevalent, since even 'unpropertied managers' are part of the capitalist class and despite their background will have interests identical with it.

The large number of empirical studies examining performance differences due to the separation of ownership from control have not resolved the conflict. On the contrary, the lack of consensus in the findings of empirical research has sparked more controversy. Nyman and Silberston (1978) have charged that the cross-sectional methodology employed by empirical researchers is defective and have opted for a longitudinal case-by-case approach. An even more fundamental criticism has more recently been made by Francis (1980), who claims that most firms are unlikely ever to be controlled by managers. Instead, they will be controlled by ownership interests of some kind; by a family, by industrial capital or by financial institutions.

The performance consequences resulting from different corporate ownership structures is the subject of this book. A model of corporate enterprise is developed which extends the traditional market structure-conduct-performance model of industrial organisation to take account of the internal organisation of firms, firm maturity and capital market restraints on managerial decision-makers. While the foundations of the model are derived from the 'new' or 'managerial' theories of the firm, attention is focused not on the establishment of *a priori* hypotheses regarding the relative performance consequences of a separation of ownership from control, but on the more fundamental question of the effectiveness and operations of the various incentives, market and non-market restraints acting on managers.

The new theoretical and empirical approaches adopted in this study allow us to consider some fundamental questions which have arisen owing to developments in corporate securities markets in the past 20 years. Foremost among these are the implications of the decline of the individual investor and concurrent rise of financial institutions for the behaviour and performance of the corporation. Close co-operation between financial institutions and corporate management have long characterised the French, German and Japanese economies. Some observers have held that this has contributed to the generally fine performance of those economies. In the Anglo-American economies some isolated studies have investigated the effects of financial institutions on capital market efficiency and some useful case-study material has been documented. However, no cross-sectional study has considered the effects of financial institutions on corporate profitability, growth or payout policy. Similarly, the performance implications of intercorporate shareholdings have received limited attention in the literature.

The empirical work is based on comprehensive data on the ownership structures of 226 listed Australian corporations. However, the theory is meant to be general in that it is structured on the assumption of an advanced capitalist economy, with its attendant cultural setting and institutional framework. Since cultural and institutional differences as well as timing differences in the process of capitalist development do occur between such countries, it is perhaps appropriate at this point to establish the international perspectives of this study.

The fundamental message of this book is that it is not the separation of ownership from control *per se* which is important, but rather the tradeoff between managerial incentives and market restraints. Cultural influences and tradition are important in determing the managerial reward system which develops in any country. In this connection we find that France and Germany (Dyas and Thanheiser, 1976, pp. 310–14) are similar to Australia, with a relatively small proportion of total executive remuneration being composed of non-salary incentive rewards. Experience in the United Kingdom, however, suggests that variable reward systems are more popular there, but still fall short of the extensive schemes practised in the United States.

The available evidence suggests that in Western Europe, as in Australia, families have tended to retain control of public corporations for a longer period than in the United States. Similarly, the concentration of institutional stockholdings has been higher in Europe and Australia. While Nyman and Silbertson (1978) found the registers of a number of UK corporations were dominated by financial institutions, the concentration of such holdings is even higher in Australia. In this sense, Australia is well advanced in relation to the trends to institutional dominance which are developing in the US and UK. Yet the extent of institutional control in Australia is still far less extensive than that already apparent in Germany. Again, in terms of organisational structures, and in the extent of diversification, the US is ahead with more conglomerates and the concomitant growth of multi-divisional structures. Holding company structures are relatively more common in Europe and Australia.

International similarities and differences also appear at the board of directors level. The US, UK and Australia have one board composed of external appointees who may or may not represent specific interests and some executive directors. Since 1966 France has operated an optional two-tier system based on the German model. In a formal two-tier system an executive board performs its duties under the direct control of a supervisory board (Grossfeld and Ebke, 1978). The legal system may exert other influences on control arrangements. In Germany, for example, the corporation law grants power of veto to stockholders with a holding of 25 per cent or more, which helps facilitate bank control. On the other hand, continental European laws tend not to place as much emphasis on the anti-trust aspects of interlocking directorships as the US laws do (when, in fact, there is less reason to have them in the US) and there is less emphasis on insider trading provisions.

All in all, the capital markets of the US, UK and Australia are freer, with more trading and a greater flow of information. This extends also to the market for corporate control. Takeover raids are much less common on the European Continent. However, mergers do take place after deliberations between parties as to the commercial advantages. Probably the main reason for the absence of market raids is the fact that the concentration of stockholdings is greater on the Continent; however, it might also reflect the thinness of capital markets, or even cultural traits. Thus, the market for corporate control is a phenomenon largely restricted to the Anglo-American economies (Daems, 1978; Davies, 1982).

The upshot of this discussion is that the process of capitalist development has been and will continue being uneven between capitalist countries. It is influenced by the size of the economy and by its cultural, legal and institutional framework. Bearing in mind the differences and similarities outlined above, it would appear that the present study, in employing Australian data, will provide particularly useful insights into aspects of the corporate structures developing in Australia, Canada, the US and the UK, in short, the Anglo-American economies. However, one cannot rule out the applicability of various aspects of the analysis to continental Europe.

The structure of the book is as follows. The 'managerial growth hypothesis' and a number of the empirical studies which it spawned are examined in Chapter 2. On the basis of a literature review and sensitivity analysis of the data, it is concluded that new theoretical and methodological approaches are required. The new theoretical structure is outlined in Chapter 3. In chapters 4 through 7 the new methodology is employed in a series of empirical tests of the main hypotheses. The final chapter presents the conclusions and implications for the study of industrial organisation, for the theory of the firm and for the main players — shareholders, managers and policy makers.

A New Approach

The approach adopted in this book is based on the traditional market structure-conduct-performance triad. Given the basic conditions of demand and supply, the primary causal link in the traditional model is assumed to flow from market structure, to conduct to performance. Various feedback loops are also envisaged; conduct may affect structure through artificial product differentiation and advertising cost barriers to entry; predatory pricing behaviour might alter the number of sellers; research and development could alter the basic technological conditions. However, much of the empirical work in this field has taken the view that conduct is the inevitable result of structure. Increasingly, though, this contention is being challenged, despite the major problem of constructing adequate proxy measures of conduct.[2] But conduct, or decisions taken at the firm level, can have a significant impact on performance once the area of discretion defined by the structural attributes of the market has been determined.

The extended model of industrial organisation which forms the core of this study focuses on the corporation, rather than the market, as the logical unit of analysis. A schematic representation of the model is presented in Figure 1.1. In essence, the model views potential corporate performance as having an upper boundary determined by the degree of discretion (in the product market) which is available to managers. Ultimately this discretion is dependent upon the market power available to the firm, that is, on such factors as market share, concentration and barriers to entry. But the extent to which managers can take advantage of this discretion is defined by the effectiveness of internal and external (stock market) restraints on their behaviour. How managers will use these residual discretionary powers, however, will depend on their incentive structure.

The major difference between the traditional model of industrial organisation and the model developed here is that, in the former, conduct (and therefore performance) is determined solely by market structure, with tacit recognition of the influence that decisions by regulatory agencies could have on the results. In our extended model, observed conduct and performance are the outcome of conflict between internal organisation, market structure (the product market restraint) and the restraints imposed by the capital and corporate control markets. Firm maturity, or the level of investment opportunities, is expected to modify the incentives and restraints originat-