

**CORPORATE
OWNERSHIP & CONTROL**

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СОБСТВЕННОСТЬ И КОНТРОЛЬ**

Postal Address:

Postal Box 36
Sumy 40014
Ukraine

Tel: +380-542-611025
Fax: +380-542-611025
e-mail: alex_kostyuk@mail.ru
alex_kostyuk@virtusinterpress.org
www.virtusinterpress.org

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Почтовый ящик 36
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Украина

Тел.: 38-542-288365
Факс: 38-542-288365
эл. почта: alex_kostyuk@mail.ru
alex_kostyuk@virtusinterpress.org
www.virtusinterpress.org

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EDITORIAL

Dear readers!

This issue of the journal *Corporate Ownership and Control* is entirely devoted to the 75th anniversary of the essential work *The Modern Corporation and Private Property* by Adolf Berle and Gardiner Means.

Over the past seven decades, experts in corporate and securities law, management consulting and academia have wrestled with reconciling the diverging interests of those who own corporations and those who control them. Corporate and securities laws have approached this problem from one direction: protecting the interests of shareholders from potentially self-serving actions of management. Management experts and economists have approached the issue from a different perspective: aligning the interests of management with shareholders, so that conflicts of interest between managers and shareholders disappear. The corporate scandals of the past few years – Enron, Worldcom, Vivendi, Parmalat and others – have shown that the tension has yet to be resolved.

Adolf Berle and Gardiner Means pointed out 72 years ago, the modern public corporation is characterised by a separation of ownership and control. This fact means that modern public corporations are also subject to a type of agency problem not usually found in other forms of economic organisation. In modern corporations, the managers – who decide how a corporation's capital is spent, how resources are allocated and what endeavours the corporation undertakes – do not themselves own the capital or resources. Those in control of the corporation,

“and therefore in a position to secure industrial efficiency and produce profits, are no longer, as owners, entitled to the bulk of such profits... The explosion of the atom of property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use.”

Berle and Means believed this led to one simple, inescapable conclusion:

“[W]here the bulk of the profits of enterprise are scheduled to go to owners who are individuals other than those in control, the interests of the latter are as likely as not to be at variance with those of ownership and...the controlling group is in a position to serve its own interests.”



In the honor of
*Adolf Berle and Gardiner
Means*

This occurred for a number of reasons, foremost being the dispersal of shareholding ownership in big corporations: the typical shareholder is uninterested the day to day affairs of the company, yet thousands of people like him or her make up the majority of owners throughout the economy. Therefore, ownership structure was the main factor contributing to solving or ignoring the separation of ownership and control problem.

What has changed over the last 75 years? Have the owners become more active in protecting their rights? Have they learnt the art of corporate governance enough to prevent managerial opportunism, entrenchment, irrational behaviour? Are shareholders effective now in making managers following the shareholders' interests?

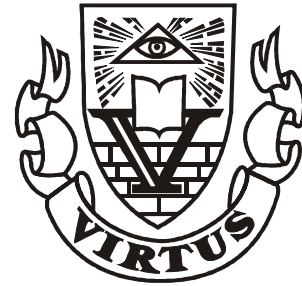
We hope that these questions are answered with a high degree of success by our contributors. Authors of the papers investigated the problem of separation of ownership and control in many countries such as the USA, New Zealand, Portugal, Brazil, Turkey, Korea, Bulgaria, Hungary, Estonia and Europe in a whole including Germany, Italy and France. Both Anglo-Saxon and Continental corporate governance practices have been covered by the authors.

We hope that their papers will be a fruitful soil for revisiting the separation of ownership and control issue once again.

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The once dominant and inconsiderate player in corporate governance, the shareholder, has faced increasing pressure from its rival stakeholders (creditors and the general public) and their agents (i.e. the management and directors) eager to unproportionately increase their stake. The idea of shareholder primacy in corporate governance is while previously was losing its dominance as corporate law versus stakeholder theory could be set for an even stronger come back.

IMPACT OF MANAGERIAL OWNERSHIP ON CAPITAL STRUCTURE: A SURVEY OF TURKISH FIRMS

Özgür Arslan*

Abstract

This paper investigates the relationship between insider ownership and capital structure decisions made by managers for an emerging market. Therefore, we survey managers of 103 firms listed in the Istanbul Stock Exchange (ISE). Our findings lend considerable support to our expectation that leverage, debt maturity and dividend issues reduce ability of managers to divert resources from value maximisation. However the same monitoring and disciplining tax is not observed for stock issues. Also, our findings document that managers of firms listed in the ISE do not opt to dividend smoothing policy. Finally, the results are in line with our expectation that, the more willing are the managers to reduce asymmetric information between them and shareholders, the higher their ownership level in firms.

Keywords: Insider ownership, agency costs, capital structure

* *Department of Business Administration, Faculty of Economics and Administrative Sciences
Hacettepe University, Beytepe 06800, Ankara, TURKEY
arslan@hacettepe.edu.tr*

Introduction

Modigliani and Miller (1958) show that capital structure decisions have no impact on firm value. Since their seminal work researchers have been finding evidence for the role of capital structure choices in increasing firm value, in the light of capital market imperfections¹. Being one of the main fruits of capital market imperfections, agency conflicts exist between firm managers and owners because of the separation of ownership from control in firms. Consequently, managers pursue capital structure choices that enhance their interests rather than that of shareholders². In accord with this, there is an extensive empirical and theoretical research on how corporate ownership structure influences capital structure choices².

Renneboog (2000) states that capital structure decisions can be considered as a monitoring device as it triggers corporate control actions. Therefore the aim of this paper is to investigate relationship between managerial ownership levels in a firm and the decisions of managers made for capital structure. In this sense, a comprehensive survey of managers of firms listed on the Istanbul Stock Exchange (ISE) is conducted for our analysis. Then, we combine their

managerial views on capital structure with their stock ownership levels in firms. Consequently we aim to understand if differences in the ownership level creates differences in the choices as well.

We contribute new evidence to corporate governance by focusing on Turkish case. First of all, Love (2003) and Khurana, Martin and Pereira (*in press*) show that capital market imperfections are more severe for emerging markets. Being an emerging market, Turkey provides a good field to study conflicts of interests between managers and shareholders in severely imperfect capital market conditions. Furthermore, Turkey is a civil law country and according to La Porta et al. (1998) protection of Turkish investors is weaker than that of their US and UK counterparts. Consequently, there is likely to be a superior opportunistic behavior on the part of entrenched managers in Turkey. Finally our study on the relationship between insider ownership and capital structure is particularly important for firms because a good corporate governance is associated with a lower cost of capital as shown by Claessens (2006).

Our findings show that the role of both leverage and debt maturity in reducing agency costs due to conflicts of interests between managers and shareholders intensifies monotonically with decreasing levels of insider ownership. Furthermore, while our analysis provides no evidence on corporate governance role of stock issues, dividends are found to discipline managerial activities. Finally, aligning to our expectations, managers become less willing to

¹ See Myers (2001) for the survey.

² See for instance, Kim and Sorensen (1986), Miguel and Pindado (2001), Short, Keasey and Duxbury (2002) and Gugler and Yurtoglu (2003).

reduce information asymmetry between them and shareholders as their insider ownership level reduces.

Our paper is organised as follows. The next section reviews previous studies and introduces the structure of our survey. This is followed by the methodology section. We report our empirical findings before presenting a summary and conclusion.

Previous Studies

Jensen and Meckling (1976) argue that introduction of managerial share ownership may align the interests of managers and shareholders and hence reduce the agency problems. Therefore we aim to see if insider ownership, as an agency cost mechanism, influences capital structure choices. Moreover, Schleifer and Vishny (1997) show that complementary intervention of both internal and external control mechanisms in Anglo-American countries maintain managerial performance. However disciplinary function of the take over market in Turkey is very weak. Similarly, lack of efficient monitoring by financial institutions³ lead managers in Turkey to be more likely to be entrenched. For this reason, we focus on the capital structure decisions as a substituting performance maintaining tool for managers in differing managerial equity ownership intervals.

Leverage is a very important item in capital structure decisions. Grossman and Hart (1982) show that managers commit themselves to work hard by issuing debt. In the event of default, creditors have the legal standing to both review managerial decision and to have management replaced through the courts, whereas shareholders do not have this power. Similarly, Jensen and Meckling (1976) and Jensen (1986) theorize that debt causes the decisions that managers make to be more aligned with the interests of shareholders in the sense that debt reduces free cash and hence less resources are left for entrenched managers to waste on unprofitable activities. In this sense, Denis and Sarin (1999) and Holderness, Kroszner and Sheehan (1999) find evidence of a negative effect of leverage on the firm's level of insider ownership. Moreover, maturity structure of corporate debt is also shown to be a factor in mitigating conflicts of interests between managers and shareholders because short term debt has superior ability to overrule management compared to long term debt (See, Datta, Iskandar-Datta and Raman, 2005 and Arslan and Karan, 2006 for Turkish firms). Consequently our first questions to managers are about their decisions related to their leverage and corporate debt maturity structure.

Our survey also includes questions about decisions on dividends. Rozeff (1982) and Easterbrook (1984) argue that high dividend pay out firms incur capital monitoring, thereby managerial discretion over resources decreases. Besides, Pindado and De la Torre (2006) consider dividend as a way of

encouraging managers for the possession of higher stakes in the firm because received dividends are tax deductible. Therefore we investigate the relationship between insider ownership level and dividend choices. However, dividend decisions should be approached with a caution because management is generally reluctant to reduce dividends unless a reduction is unavoidable (Michaely, Thaler and Womack, 1995.) This situation is the outcome of the fact that dividend cuts or omissions are associated with unusually poor stock price due to adverse interpretation from stock market (Healy and Palepu, 1988).

We also consider disciplining role of the market for the stakes. Renneboog (2000) states that a market for share stakes might play a monitoring role on management. In this sense, we reason that stock issues is another tool to force managers to act in accord with the benefits of shareholders. Therefore the views of managers in different ownership intervals on issuing stock reflect their perception on the monitoring and disciplining role of stock market.

We report the views of managers belonging to different ownership intervals because Stulz (1988) formalize that there is a concave relationship between firm valuation and increase in managerial ownership. First of all, increased managerial ownership is expected to result in improved firm performance since managers are less likely to divert resources away from value maximisation. However, at a certain level of managerial ownership management becomes entrenched because outside shareholders find it difficult to monitor the actions of managers then. Consequently benefit of consumption of perquisites for managers may outweigh the loss they suffer from a reduced value of firm⁴. Therefore, we consider this likely non-monotonic relationship between managerial ownership and alignment of shareholder and managerial interests by reporting the survey results in four distinct insider ownership levels.

Agency conflicts are mainly generated by asymmetric information between owners and controllers of firms. Thus, we also incorporate extra information about the views of managers on the tools reducing the asymmetric information between them and shareholders such as ways to enhance transparency through timely and accurately informing shareholders. This way, we aim to clarify the discrepancies between the different insider ownership levels for efforts to mitigate conflicts of interests in firms.

Methodology

Our sample consists of a total of 103 firms listed on the ISE. In 2005 the total number of firms listed on the ISE is 292. After excluding the financial firms

³ See Arslan and Karan (2006).

⁴ For evidences see, Morck, Shleifer and Vishny 1988; McConnell and Servaes, 1990 and Ozkan and Ozkan, 2004 for UK firms.

from the sample the total number of firms we have sent the surveys to managers, namely, chief financial officers (CFO) or chief executive officers (CEO) is 245. We have e-mailed, mailed and faxed the survey between March 2005 and July 2005. Owing to the shortness of our survey containing not in excess of 20 questions, our response rate is 42 percent which is much higher than those of other similar studies conducted through surveys⁵. Furthermore, managerial stock ownership levels are obtained from the yearbook of ISE companies, which is a country-specific source and published by the Department of Documentation of ISE at the end of each year. It provides data on the first level of shareholding for all publicly traded companies in Turkey, and lists names of owners, numbers of declared shares and percentage of ownership.

[Insert Table 1 About Here]

Table 1 shows the allocation of the survey respondents to one of the ten broad economic groups. According to the table our sample is not concentrated on particular sectors and leading ones are food and textile industries, comprising 18.45 percent and 16.50 percent of the sample respectively. These industries are followed by chemical, trade-services, electronics industries, metal industries and their rankings in the sample are 12.62 percent, 10.68 percent 8.74 percent and 7.77 percent respectively. The least number of replies that take place in our study belong to the transport, building and paper industries with participating only 7, 6 and 5 firms respectively.

[Insert Figure 1 About Here]

We divide the managerial ownership levels into four groups and Figure 1 portrays these managerial ownership intervals which we base our analysis on. The vertical axis of the figure represents the percentage of the whole sample and the horizontal axis demonstrates the managerial ownership intervals. Managers having the ownership level less than 5 percent in firms form only 19 percent of the sample. Moreover, the percentage of managerial ownership level that falls to the percentage between 5 and 10 in the whole sample is 17. The highest ranking insider ownership interval is the one between 10 and 20 percent and it comprises 34 percent of the sample. It is followed by the managerial ownership level exceeding 20 percent and it covers the 30 percent of the sample. The results confirm the finding in Yurtoglu (2000) that ownership structure of Turkish firms are characterised as having high level of insider ownership. Hence, the ownership structure of Turkish firms are highly concentrated and differs from those of Anglo-Saxon counterparts which are characterised

by dispersed ownership levels. Accordingly, our results also differ from those obtained for the executive stock ownership levels by Bancel and Mittoo (2004) for European countries. Their findings show that the majority of insider ownership level is below 5 percent and the number of firms that falls to this interval exceeds 85 percent of the sample. Sum of the ownership levels taking place in the other three intervals, namely between 5 and 10 percent, between 10 and 20 percent and those exceeding 20 percent comprise less than 5 percent of the sample.

Empirical Findings

Panel A in Table 2 presents responses to the questions in the survey regarding leverage and debt maturity decisions. These questions highlight the role of leverage and debt maturity in mitigating conflicts of interests between managers and shareholders in firms. The results show that as the managerial ownership level decreases the belief that an appropriate amount of debt ensures that upper management works hard and efficiently, increases monotonically. Since the lower levels of insider ownership encourages managerial entrenchment the disciplining role of debt is more pronounced for the managers falling to the lower intervals of managerial ownership. Furthermore, our results do not document a considerable difference in responses given to the question if debt gives investors a better impression of firm's prospects. Nevertheless, we found a slim evidence that the importance of this issue for the managers that hold less than 5 percent of equity in firms is more pronounced than that of those whose ownership levels are between 5%-10%. Our results do not provide statistical significant differences among the responses given to the statement that having a close relationship with a bank encourages usage of debt. However, this issue is fairly important for our sample firms. In accord with our motive the importance level of responses given to the question "Short term debt ensures that returns from new projects can be captured by shareholders." decreases monotonically as the insider ownership level increases. This result is in line with our expectations that the role of short term debt in reducing agency conflicts between managers and shareholders is more essential for the lower level of insider ownership which encourages managerial entrenchment. On average, the managers of our sample firms find it important to maintain a target debt to equity ratio. However, the responses to this questions do not exhibit a monotonic and significant difference between the ownership intervals, whereas sample firms on average find it important to maintain the target ratios. Finally, the most definitive role of debt in agency costs is captured from the last question which asks if it becomes harder for a firm to borrow when it acts against the interest of its shareholders. The responses for this question lend considerable support to the prediction that in case of managerial

⁵ The response rate in Graham and Harvey (2001) and Bancel and Mittoo (2004) is 9 percent and 12 percent respectively.

activities having unbeneficial outcomes for firms in expense of shareholders, borrowing opportunities decrease monotonically as the insider ownership level decreases. Consequently, managers with lower ownership levels in firms feel less able to borrow in the event of conflict of interest between them and shareholders. To sum, our findings confirm that the role of both leverage and debt maturity in mitigating conflicts of interests in firm due to separation of ownership and control, is enhancing monotonically with decreasing levels of insider ownership.

[Insert Table 2, Panel A About Here]

Panel B in Table 2 exhibits responses to the questions in the survey on dividend and stock issues. The first two statements of this panel is related to the choices of managers on issuing stocks. We find that managers in the each interval are consistently not in the opinion that stock issues give a better impression of their firms' prospects than using debt, since the responses on average are close to the "not important" option. Moreover, our results show that on average managers do not resort to issuing stocks to dilute the holdings of certain shareholders. Besides, there is neither statistically significant differences nor monotonic among the insider ownership levels for responses given to both of the questions on stock issues.

The rest of the questions in Panel B aims to reveal the differences among managers, falling to four distinct ownership intervals, in their choices for dividend issues. First of all, judging into the responses given to the question 3 in the panel, we find a strong evidence that the importance of dividend in ensuring that upper management works hard and efficiently grows uniformly and significantly as the insider ownership level decreases. This finding is in accord with the literature that an appropriate amount of dividend reduces managerial entrenchment through disciplining managers. Furthermore, on average managers in the each ownership intervals find it important that dividend level should be adjusted in accord with the earnings, nonetheless there is no significant difference between the intervals for the responses. Consequently, we find that managers of firms listed in the ISE do not opt to dividend smoothing policy in order to avoid adverse reaction from the stock market in case of dividend omissions or reductions.

[Insert Table 2, Panel B About Here]

The objective of questions presenting in Panel B in Table 2 is to understand the differences among managers in their efforts to reduce the degree of asymmetric information between them and shareholders. Information asymmetry feeds the managerial entrenchment which emanates from the separation of ownership and control in firms. However increasing the transparency in firms, reduces

the value decreasing activities and decisions of managers through enhancing the timely and accurate transfer of internal information to shareholders. Generally our results show that the intention of managers to maintain the asymmetric information increases as the insider ownership level falls. These results are inline with our findings for leverage, debt maturity and dividend issues presented in the previous panels in the Table 2. First of all, as the insider ownership level falls monotonically, firms find it less important to announce their targets frequently concerning capital structure to the shareholders. Furthermore, the identical monotonically decreasing and highly significant pattern is also observed for the responses given to the statement that firms should timely disclose major managerial outcomes and decisions to the shareholders. Finally, our last aim is to reveal how important it is to announce financial reports quarterly instead of biannually or once at the end of fiscal year. The firms in our sample on average are not in the opinion that quarter announcements are important for their firms. Nevertheless, its importance for managers increases monotonically with the rise in insider ownership as expected. Obviously, managers with lower ownership levels try to sustain their entrenchment ability through not increasing transparency within their firms.

[Insert Table 2, Panel C About Here]

Summary and Conclusion

In this paper we examine how managerial ownership level affects capital structure decisions. Capital structure decisions such a leverage, debt maturity, stocks and dividends help to align interests of managers and shareholders. Following the literature on the corporate governance role of capital structure decisions, our questions are developed accordingly and we conduct our survey to managers of firms listed in the ISE. Responses to the survey are divided into the four managerial ownership level in order to find out if managerial entrenchment motive is a monotonic process. Our survey is conducted on 103 firms in the year 2005. Having a 42 percent response rate to the survey, our analyses encompasses relatively higher number of firms from the chosen sample of firms than the similar studies.

Our study sheds more light on the capital structure decisions of managers given that the analyses are conducted in an emerging market, in which capital market imperfections are stated to be more severe than developed markets. Moreover legal protection of investors are weaker in Turkey and this results in the enhanced role of capital structure choices to reduce managerial discretion over resources.

The results obtained through responses to the survey confirm that leverage and debt maturity reduces managerial discretion over resources. On the contrary the same disciplining and monitoring role is

not obtained for the stock issues. Moreover, dividends are also found to limit managers to divert resources away from value maximisation. Additionally we found that managers of our sample do not opt to dividend smoothing policy by rather resorting to adjusting dividend payments in accord with the earnings. Besides, we investigated opinion of managers to increase transparency of their decisions and activities. The results are in line with our expectations and show that the more willing are managers to reduce asymmetric information between them and shareholders, the higher ownership level they have in firms. Finally, due to monotonic improvement of corporate governance roles of capital structure choices along with the fall in insider ownership, our results do not support the concavity of the relationship between managerial entrenchment and insider ownership.

The evidence documented in this paper is based on the analysis of firms in a single emerging market country. More investigation is needed to explore the relationship between insider ownership level and managerial decisions of capital structure in emerging markets. This is an area for future research since such an analysis would further allow us to investigate the effect of country-specific characteristics, such as macro-economic, legislative and institutional system, on these issues.

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Appendices

Table 1. Allocation of companies to one of ten broad economic groups

Sub-Sector	Number of Companies	% Companies
Energy	8	7.77
Transport Industry	7	6.80
Textile Industry	17	16.50
Building	6	5.83
Trade-Services	11	10.68
Food-Industry	19	18.45
Metal Industry	8	7.77
Chemical Industry	13	12.62
Paper Industry	5	4.85
Electronics	9	8.74

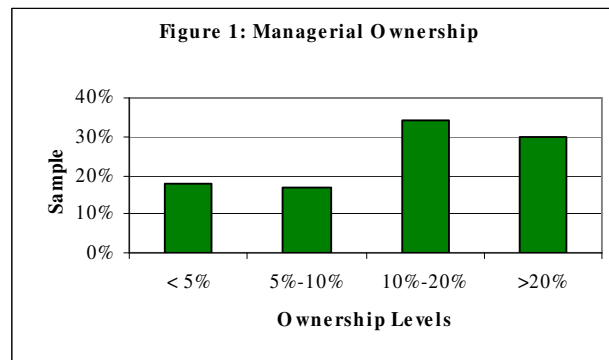


Table 2. Survey Responses

Respondents are asked to rate the following questions on a scale of 0 (not important) to 4 (very important). Mean represents the mean value of scales obtained from the entire sample. ***, **, * denotes a significant difference at the 1%, 5% and 10% level, respectively.

Panel A: Responses on Leverage and Debt Maturity		Managerial Ownership Intervals				P-values for Univariate T-test for Difference in Means					
	Mean	<5%	5%-10%	10%-20%	>20%	<5%=5%-10%	<5%=10%-20%	<5%=>20%	5%-10%=10%-20%	5%-10%=>20%	10%-20%=>20%
1) An appropriate amount of debt ensures that upper management works hard and efficiently	2.67	3.42	2.97	2.43	1.87	0.25	0.065*	0.009**	0.35	0.054*	0.11
2) Using debt gives investors a better impression of our firms' prospects	1.62	2.06	1.69	0.96	1.76	0.48	0.09*	0.83	0.29	0.87	0.12
3) We use debt because of our close relationship with a bank	2.75	2.89	2.71	2.96	2.44	0.92	0.94	0.42	0.73	0.64	0.63
4) Short term debt ensures that returns from new projects can be captured by shareholders	1.98	2.93	2.51	1.42	1.07	0.67	0.002**	0.003**	0.071**	0.04**	0.44
5) One of our main goal is to maintain a target debt-to-equity ratio	3.03	3.02	2.85	3.31	2.85	0.84	0.81	0.84	0.71	1.00	0.70
6) It becomes harder for a firm to borrow when it acts against the interest of its shareholders	1.64	2.75	2.23	1.05	0.54	0.72	0.004**	0.002**	0.082**	0.024*	0.14

Panel B: Responses on Dividend and Stock Issues		Managerial Ownership Intervals				P-values for Univariate T-test for Difference in Means					
	Mean	<5%	5%-10%	10%-20%	>20%	<5%=5%-10%	<5%=10%-20%	<5%=>20%	5%-10%=10%-20%	5%-10%=>20%	10%-20%=>20%
1) Issuing stock gives a better impression of our firms's prospects than using debt	0.84	0.75	1.34	0.59	0.66	0.27	0.91	0.89	0.23	0.39	0.82
2) We issue stocks to dilute the holdings of certain shareholders	0.90	1.10	0.84	0.75	0.87	0.53	0.36	0.43	0.85	0.92	0.70
3) An appropriate amount of dividend ensures that upper management works hard and efficiently	1.75	2.64	1.89	1.48	0.99	0.021*	0.059*	0.001**	0.09*	0.014**	0.044**
4) Dividend level should be adjusted in accord with earnings	3.35	3.56	3.24	3.42	3.19	0.57	0.89	0.49	0.69	0.83	0.86

Panel C: Responses on Transparency		Managerial Ownership Intervals				P-values for Univariate T-test for Difference in Means					
	Mean	<5%	5%-10%	10%-20%	>20%	<5%=5%-10%	<5%=10%-20%	<5%=>20%	5%-10%=10%-20%	5%-10%=>20%	10%-20%=>20%
1) Firms should frequently announce their targets concerning capital structure to shareholders	2.86	2.30	2.94	3.02	3.16	0.027**	0.021**	0.018**	0.95	0.89	0.94
2) Firms should timely disclose major managerial outcomes and decisions to shareholders	3.10	2.67	3.10	3.21	3.42	0.048**	0.008***	0.003***	0.89	0.52	0.75
3) Firms should quarterly announce their financial reports	1.54	1.03	1.19	1.71	2.24	0.76	0.044**	0.005***	0.32	0.09*	0.26

DETERMINANTS OF THE CORPORATE GOVERNANCE OF KOREAN FIRMS

Eunjung Lee*, Kyung Suh Park**

Abstract

This paper investigates the determinants of the corporate governance of the firms listed on the Korea Stock Exchange. We find that ownerships by controlling shareholders tend to have negative effects on their corporate governance, and the negative effects are more significant on the board structure and the managerial transparency of the sample firms. On the other hand, foreign shareholders exercise positive effects while institutional investors are shown to be passive on the corporate governance issues. The empirical results suggest that investors' or regulator's effort to improve the corporate governance of Korean firms should be directed to the improvement of the board structure and managerial transparency.

Keywords: Corporate Governance, Board Structure, Managerial Transparency, Controlling Shareholders, Institutional investors, Foreign investors

* BK Assistant Professor, Business School, Seoul National University, 56-1, Shinrim dong, Kwanak-kyu, Seoul, Korea. Tel: 822-880-2523, E-mail: lej@snu.ac.kr.

** Professor, Business School, Korea University, 5-1 Anam-dong, Sungbuk-kyu, Seoul, Korea. Tel: 822-3290-1950, Fax: 82-2-3290-1950, E-mail: kspark@korea.ac.kr.

1. Introduction

In this paper, we investigate whether the block shareholders of Korean firms such as controlling shareholders or institutional investors exercise any influence on the corporate governance structure of those firms. We extend the existing research on the issue by analyzing the specific area of corporate governance mechanisms these block shareholders would exercise their influence on. We conjecture that major shareholders who maintain a certain level of ownership have economic incentives to affect the corporate governance of their firms, and would intervene in the decision on their corporate governance structure. Especially, we focus on the incentives of controlling shareholders, foreign investors and institutional investors as major shareholders.

For the analysis, we use the firms listed on the Korea Stock Exchange. Korean firms are the subject of interesting academic research since most of them have controlling shareholders, who actively participate in the management of their companies and as such are called 'owner-managers' (Jang, Kang and Park(2004)).

Korean firms also allow us to overcome the endogeneity problem in the analysis of the relationship between ownership and corporate governance as existing papers have shown (Lee, Park and Jang (2004)). While ownership structure generally affects governance structure, governance structure also affects ownership structure in a long run. For example, institutional investors would prefer to invest in companies with good corporate governance, which in

turn increases the ownership of outside investors. However, it has been less than a decade that corporate governance has attracted the attentions of policy makers and corporate managers in Korea, and the Korean data allows us to resort to one-direction empirical analysis.

For the convenience of analysis, we select several measures of corporate governance that can be easily identified and quantified. First one is the total corporate governance scores surveyed and prepared by the Korea Corporate Governance Service, a public entity under Korea Stock Exchange. We then divide the total scores into six categories such as shareholder rights, board structure, board operation, disclosure, audit system, and dividend policy. As conjectured, the empirical analyses show that insiders negatively affect the corporate governance of Korean firms and the negative effects are most significant in the area of shareholder rights and board structure.

After this introduction, Section 2 overviews existing literatures, Section 3 develops hypotheses for empirical tests, Section 4 describes the data and the empirical results, and Section 5 concludes with some policy implications.

2. Existing Literatures

Many papers have dealt with the determinants of corporate governance. Weisbach (1988) and Klein (2002) look into the incentives of insiders of US firms and show that there exists a negative correlation between the ownership of managers and the proportion

of outside directors on the boards of directors, or on audit committees. Shivdasani and Yermack (1999) claim that the CEOs of US firms exercise major influence on the selection of new directors when the ownership distribution of his firm is dispersed, while it is the controlling shareholder under concentrated ownership structures. Recently, Durnev and Kim (2003) show that firms with good investment opportunity, higher sales growth rates and higher dependency on external financing would maintain a better corporate governance not to lose those good investment opportunities.

For the papers that deal with Korean firms, Lee, Park and Jang (2004) analyze the role of controlling shareholder in his decision on board structure and the introduction of cumulative voting system in Korea companies. Lee, Park and Jang (2005) also analyze the incentive of controlling shareholders on the overall corporate governance of Korean firms. In both papers, they find that controlling shareholders have negative effect on the corporate governance of their firms.

In this paper, we analyze which part of the corporate governance the negative or positive effect of major shareholders are concentrated on. We use the corporate governance scores of the Korean companies listed on the Korea Stock Exchange during the period of 2001 through 2003. Compared with existing research on corporate governance of Korean firms, the data we use comprises more detailed information on the subcategories of corporate governance such as shareholder rights, board composition, managerial transparency, audit system, and cash payout policy of sample firms. Therefore, we can derive more specific policy implications on the role of insiders and outsiders in their decision on corporate governance.

As in Lee, Park and Jang (2004 and 2005), this paper tests two competing hypotheses regarding the relationship between ownership and corporate governance. First, it would be a natural choice for a firm to optimize on the use of governance mechanism since it is costly, and there would be a substitution effect between governance and the concentration of ownership. For example, institutional investors can be a good monitor on the management and as such they can substitute for other governance mechanism such as outside directors. Second, block shareholders who have major ownerships in their firms might prefer a stronger monitoring system to protect their stakes, in which case we would observe a positive correlation between block ownership and governance, which we term as a complement hypothesis. This paper tests whether specific types of investors tend to substitute for governance mechanisms or reinforce them.

The Korean economy is an interesting subject of analysis since it is dominated by chaebols and controlling families. The controlling shareholders of Korean chaebols maintain their control with the help of affiliated ownerships as well as their family ownerships, and no outsiders can possibly challenge their control, mainly due to the interlocking ownership

structures among affiliates, even though their capability and integrity as managers are in doubt.

3. Hypotheses and Variables

This section develops empirical hypotheses that relate corporate governance to firm characteristics based on existing theories and empirical results, and identifies variables that will be used to test the hypotheses.⁶

3.1. Ownership and Corporate Governance

Ownership structure is a part of corporate governance in its broad sense, and it also affects other elements of corporate governance. Controlling shareholders have a strong incentive to monitor the management of firms and can be the most important part of corporate governance. Existing theories and empirical studies that analyze ownership structure generally identify block shareholders such as corporate shareholders, institutional investors and financial institutions as monitors in addition to controlling shareholders.

In this paper, block shareholders are assumed to affect the corporate governance of a firm in two ways, which lead to two competing hypotheses. The first one, which we term the 'substitute hypothesis', assumes that higher ownerships of block shareholders would act as a substitute for other governance mechanisms as the latter incurred costs to companies. Firms thereby adjust the level of corporate governance given the monitoring role of block shareholders. This would be more the case if block shareholders actively monitored the management of their firm.

On the other hand, as Durnev and Kim (2003) have claimed, higher ownership may induce block shareholders to further improve the corporate governance of their firm as they will have a larger economic stake to protect. This is what we call the 'complement hypothesis'.

It is our conjecture that one of these hypotheses would more likely hold depending on who the block shareholders are. A controlling shareholder who usually participates in the management of his firm may not find it palatable to have a governance structure which monitors the management too tightly if he derives private benefit of control. This, however, would not be true for institutional investors who have no such control benefits and only seek higher firm value.

Therefore, we may observe a less strict monitoring mechanism with increasing ownership by controlling shareholders, which we may alternatively term the 'control hypothesis' to further differentiate it from the substitute hypothesis, as their purpose is not to save monitoring costs, but to secure more control. Of course, it is not easy to differentiate between these two

⁶ See Durnev and Kim (2003) and Lee, Park and Jang (2004) for more detailed derivation of empirical hypotheses and variables to be used in an empirical analysis of the determinants of corporate governance.

hypotheses empirically since we would observe the same direction of signs for the coefficients for the controlling ownership variable in both cases. We test diverse empirical models and use proxy variables to obtain a better understanding of the incentives of controlling shareholders.

We also analyze the role of ownership by affiliated companies, which provides interesting information about the incentives of controlling shareholders. As affiliated firms are under the control of controlling shareholders and usually do not intervene in the management of other affiliates, their existence would not substitute for the internal monitoring function. Therefore, if we observe a negative effect of affiliated ownership on the governance scheme, that is a strong indication that controlling shareholders exploit the affiliated ownership only to fortify their control by resisting outside monitoring.

La Porta, Lopez-de-Silanes, Shleifer and Vishny (1999) interpreted affiliated ownerships as representing the discrepancy between the cash rights and the control rights of controlling shareholders, which tends to lower firm value. We interpret the affiliated ownership as a device to resist the introduction of a new monitoring mechanism, thus eventually leading to lower firm value.

It would also make some difference if a block shareholder assumed a management position and so officially participated in the management of his firm. A dummy variable, which takes a value of 1 if the CEO has more than 5% ownership and 0 otherwise, would be used.⁷ We conjecture that its coefficient would be negative as the owner-manager would have a stronger incentive to resist outside monitoring since he is now more of a manager than a shareholder. On the other hand, controlling shareholders in Korean firms are supposed to have full control of the management even if they have no official positions. In this case, the CEO dummy may not have any effect on the governance of a firm.

One technical issue that needs to be resolved concerns the use of ownership variables in the empirical model. We have considered only the effect of ownership on corporate governance in the discussion. But, the truth is that governance can also affect ownership structure. A good example would be an investment strategy based on corporate governance, employed by some institutional investors in their portfolio management. In that case, firms with good corporate governance would have higher outside ownership and naturally lower inside ownership, and we would observe a positive correlation between institutional ownership and corporate governance, but a negative relationship between controlling ownership and corporate governance. This reversed causality would lead us to falsely accept the complementary

hypothesis for institutional investors and the control hypothesis for controlling shareholders.

Previous studies such as Mak and Li (2001) used simultaneous empirical models to tackle the endogeneity issue. One problem with using a simultaneous model is that we need an instrumental variable which is correlated with one dependent variable, but not with others. However, existing papers are not very thorough in this aspect mainly because identifying such a variable is not an easy task.

In this regard, our Korean samples offer a good solution to the endogeneity issue since the corporate governance mechanisms we are going to analyze were introduced mainly after the economic crisis, and so not much time has passed for them to affect the ownership structure of Korean firms. Even Mak and Li (2001) argued that it is ownership that affects corporate governance, but not the other way round. We also used lagged variables for ownership and other firm-specific variables to further minimize the endogeneity problem.

3.2. Business Structure and Corporate Governance

Another major factor that can affect the governance structure of a firm is business structure, and conglomerates have been a focus of interest since they offer a very comfortable environment for controlling shareholders to pursue their own benefits through transactions among affiliated firms. Tunnelling, as it is known in the literature, has been widely reported in European conglomerates by Johnson, La Porta, Lopez de Silanes and Shleifer (2002), and also in Korean conglomerates by Bae, Kang and Kim (2002). A conglomerate business structure also allows controlling shareholders to maintain their control through affiliated ownerships.

In this paper, we use a dummy variable which takes a value of 1 if a firm belongs to one of the 30 largest chaebols as defined by the Korea Fair Trade Commission for their regulatory purpose. We conjecture that those firms that belong to a chaebol suffer from the agency problem more than independent firms do, and therefore may have a more stringent monitoring mechanism as demanded by outsider investors. But, the dominance of controlling shareholders through affiliated ownership may also weaken it. This will be confirmed by empirical analysis.

3.3. Firm Size and Corporate Governance

Since governance mechanisms consume corporate resources, we expect that larger firms would have better corporate governance, and we include asset size as a control variable. Most of the monitoring system such as the board of directors, internal control system, and financial reporting and disclosure system incur financial costs, most of which are of a fixed component and can be borne more efficiently by larger firms. The more complicated business structure of

⁷ It would have been better if we had a dummy variable denoting whether the controlling shareholder has a position in his company or not.

large firms may also require better corporate governance.

We also use a dummy to accommodate the effect of regulatory requirements on corporate governance based on asset size.⁸ A dummy variable, which takes a value of 1 if the total asset size of a firm exceeds 2 trillion won, and 0 otherwise, is included.

3.4. Other Financial Characteristics and Corporate Governance

We also expect that some financial characteristics would affect the governance decision and need to be controlled. We include control variables that represent profitability, liquidity, financial structure and growth rates of firms. The effects of profitability on corporate governance may be two way. High profitability implies a good capability of management and so monitoring them may not be necessary. On the other hand, high profitability means the company can afford a better governance system. Outside investors may also demand better governance as they have a greater economic stake to lose.

Higher liquidity as measured by the amount of free cash flow would lead to a better governance mechanism since it can be appropriated by the management for their private benefit. It also allows firms to maintain a costly monitoring system. The growth potential would also be related to better governance since those firms with high growth rates have more to lose from a lack of investment capital, and would try to satisfy outside investors with better governance as Durnev and Kim (2003) have argued.

We also include the debt ratio and the bank loan ratio. A higher debt ratio implies a larger amount of interests and principals to be paid periodically, and the management would be under pressure to ensure enough cash flow to cover the debt payment, which can be done through more efficient management (Grossman and Hart (1982)). We expect the debt ratio to be negatively correlated with the corporate governance mechanism. Among the different types of debt, a bank loan is of particular interest since banks, as larger creditors with a long-term relationship with firms, are supposed have an incentive and capability to monitor their client firms.

4. Data and Empirical Models

4.1. Samples and Data

We analyze Korean firms listed on the Korea Stock Exchange (KSE) as of the end of 2001 through 2003. For the financial data, we use the data from the Korea Listed Company Association. Ownership data were

⁸ The Korean listing law requires one quarter of the boards of listed firms to be filled with outside directors with the minimum number being one. The minimum proportion is increased to one half for the firms with an asset size over 2 trillion won, with the minimum number being three.

collected using the Electronic Disclosure System of the KSE, and governance data were provided by the Korea Corporate Governance Service, which is an independent corporate governance scoring agency in Korea. We exclude financial companies from our samples, leaving 438 manufacturing companies listed on the KSE. <Table 1> shows the summary statistics of the major variables. The average corporate governance score during the analysis period is 42.79 points out of the total of 100 points, and the score on shareholder rights shows the highest level of 49.04 points while the composition of the board of directors shows the lowest level of 28.69 point. The average inside ownership, which is the sum of family ownership and affiliated ownership is 32.9%. Foreign ownership is 9.8% and institutional ownership is 8.28%.

[<Table 1> here]

<Table 2> shows the correlation coefficients of the variables. Controlling ownership is negatively correlated with the corporate governance score, and also with other subcategories of corporate governance scores while institutional and foreign ownerships are positively correlated with them, as expected.

[<Table 2> here]

4.2. Empirical Models

In this section, we set up empirical models and test our hypotheses. The dependent variable is the corporate governance scores of sample firms. Cross-sectional regressions are employed to test the hypotheses reviewed in the previous section.

4.2.1. Ownership and Corporate Governance Scores

A stylized fact in the corporate governance area is that there exists a positive correlation between corporate governance and firm value. As LLSV (1999), Mitton (2002), Durnev and Kim (2003) and Black, Jang and Kim (2003) have confirmed, corporate governance matters and affects firm value.

But if this is so, then why do firms not improve their corporate governance so that their shareholder value is further increased? One possible answer is that the current state of corporate governance is already optimal. That is, it is too costly for a firm to improve its corporate governance. However, Park and Lee (2004), who test the relationship between corporate governance score and the value of Korean firms, show that the difference in the average Tobin's Qs of those firms in the highest quartile of corporate governance scores and those in the lowest quartile is about 0.39. Considering that the average market value of those Korean firms is US\$0.8 billion, a potential increase in shareholder value due to improved corporate

governance would amount to US\$0.32 billion on average, which would well exceed any costs related to upgrading the corporate governance of those firms. Park and Lee (2004) even show that individual governance mechanism such as board composition or disclosure policy, which can be rather easily upgraded, also has a positive effect on firm value.

Below, we conjecture again that the private interests of controlling shareholders would deter firms from attaining optimal corporate governance. For the empirical analysis, we use the governance scores of Korean firms collected from 2001 through 2003.⁹ The annual surveys contain over 100 questions on the corporate governance of Korean firms, and evaluate, among other factors, shareholder rights, structure and operation of the boards; disclosure and managerial transparency, and the internal control system. According to the surveys, corporate governance in Korea differs widely between firms. The advantage of using the scores instead of the individual governance mechanism is that the governance scores are more comprehensive in evaluating the overall corporate governance of a firm than a specific governance mechanism, and also that it allows us to use a larger number of samples to increase the power of the models. <Table 3> and <Table 4> show the results of panel data analyses that cover 3 years of corporate governance scoring. In regression (1) of <Table 3>, the coefficients of family ownership and affiliated ownership are both negative and significant at the 1% level, confirming our conjecture that controlling shareholders do not like good corporate governance. The significance is maintained even if we add control variables in regression (2). Other financial variables also show expected signs and significance. Sales growth and Asset sizes are both positively related with corporate governance as expected.¹⁰

Regressions (3), (4), (5) and (6) confirm the negative influence of inside ownerships on the subcategory of shareholder rights or on the subcategory of board structure. On the other hand, their negative effects on the operation of the boards or on audit system are not statistically significant when we included the control variables in regression (8) or regression (12). Regressions (9) and (10) show the negative influence of inside family ownership on the managerial transparency of the sample firms. Dividend is not significantly correlated with the inside ownerships as shown in regressions (13) and (14). These results suggest that inside ownerships can have differential effects on the subcategories of corporate governance, and outside investors or regulatory agencies who want to improve the corporate

governance of Korean firms need to focus their effort on specific areas of corporate governance.

<Table 4> on the other hand show the influence of outside investors on the corporate governance of Korean firms. Regressions show again that the effects of outside ownership can be differential depending on the categories of corporate governance. Among outside investors, foreign investors are shown to be more influential than institutional investors in their influence on the corporate governance of Korean firms. In regressions (3), (4), (5) and (6), foreign ownership is positively and significantly correlated with shareholder rights or board structures, while institutional ownership show no significant relationship.

The interaction variables between foreign ownership and chaebol dummies show positive coefficients in most of the regression models, suggesting the monitoring effect of foreign ownership is more significant when the sample firms belong to one of the 30 largest chaebol groups. However, their significance is not maintained once we add other control variables. Unexpectedly, the interaction variable between institutional ownership and chaebol dummy shows negative significance in regression (3) and (4), suggesting that institutional investors in Korean economy is less concerned about the shareholder rights of those companies that belong to chaebol groups.

5. Conclusion

This paper analyzes the determinants of the corporate governance of Korean firms, focusing on inside and outside ownerships and their effects on the special area of corporate governance. Using the data on corporate governance scores of Korean firms over the period of 2001 through 2003, the paper shows that controlling shareholders of Korean firms tend to have negative effect on corporate governance of Korean firms. We ascribe the result to the fact that the controlling shareholders of Korean firms assume a managerial role, and naturally, they try to maximize their private benefit of control by lowering the level of monitoring by outside investors.

This paper contributes to the existing literature on corporate governance by showing the special areas of corporate governance mechanisms the negative or positive effects of major shareholders are more significant. It shows that controlling shareholders tend to intervene in the decision on the board structure or the managerial transparency of their firms, while foreign investors have positive effects on the shareholder rights and the board structures of Korean firms. On the other hand, institutional investors are shown to be very passive on the issue of corporate governance of Korean firms. From a policy point of view, the paper shows that investors or regulators need to pay more attention to improving the board structures or managerial transparency, and need to seek for methods to require institutional investors to be more

⁹ The KSE initially, and then the Korea Corporate Governance Service (KCGS), a subsidiary of the KSE, has been in charge of evaluating the corporate governance of listed companies in Korea.

¹⁰ We did not use the asset size dummy in the model since the evaluation process already reflects the size factor in the scoring.

active in protecting the shareholder rights of their customers.

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Appendices

Table 1. Summary Statistics

The table shows the average values of firm specific variables for the sample firms that include 217 non-financial firms listed on the Korea Stock Exchange between 2001 and 2003. Governance variables are measured as of the end of each year, while the ownership and financial variables are measured as of the end of previous years.

	Average	Minimum	Maximum
Family ownership	0.2159	0	0.6991
Affiliated ownership	0.1148	0	0.7596
Foreign ownership	0.0980	0	0.8583
Institutional ownership	0.0828	0	0.8456
corporate governance score	42.79	20.42	82.70
Shareholder Rights	49.04	25.32	80.95
Board of Directors	37.44	7.00	88.00
Composition of the Board of Directors	28.69	0.00	92.50
Operation of the Board of Directors	43.06	9.68	91.94
Disclosures	43.87	19.35	83.87
Audit Systems	36.49	0.00	100.00
Dividend	32.06	0.00	100.00
Chaebol dummy	0.2523	0	1
Cash flow from operation	0.0734	-0.3118	0.3467
Sales growth rates	0.0732	-0.5389	1.9807
Asset size (billion won)	1,464	15	56,469
Debt to asset	0.4653	0.0621	1.1851
EBIT to asset	0.0605	-0.3811	0.3702
Operation risk	0.0280	0.0011	0.2944

Table 2. Correlation Coefficients

The sample includes 217 non-financial firms listed on the Korea Stock Exchange between 2001 and 2003. The governance-related statistics are as of the end of year, while the financial statistics are as of the end of previous year. The numbers in parentheses are p-values, and ***, ** and * denote significance at the 1%, 5% and 10% levels respectively.

	Family ownership	Affiliated ownership	Foreign ownership	Institutional ownership	Chaebol dummy	Cash flow	Sales growth rates	Asset size	Debt to asset	EBIT to asset	Operation risk
Affiliated ownership	-0.4052*** (0.0001)										
Foreign ownership	-0.3194*** (0.0001)	-0.0481 (0.2236)									
Institutional ownership	-0.2740*** (0.0001)	0.0519 (0.1893)	0.0933** (0.0181)								
Chaebol dummy	-0.3899*** (0.0001)	0.2403*** (0.0001)	0.1753*** (0.0001)	0.2665*** (0.0001)							
Cash flow	-0.0514 (0.1933)	0.0504 (0.2026)	0.2754*** (0.0001)	0.1081*** (0.0061)	0.0984** (0.0126)						
Sales growth rates	0.0569 (0.1492)	-0.0789** (0.0455)	0.1444*** (0.0002)	-0.0973** (0.0147)	-0.0675* (0.0872)	0.1350*** (0.0006)					
Asset size	-0.4088*** (0.0001)	0.1635*** (0.0001)	0.5053*** (0.0001)	0.3190*** (0.0001)	0.5032*** (0.0001)	0.2209*** (0.0001)	0.0461 (0.2439)				
Debt to asset	-0.3016*** (0.0001)	0.0569 (0.1493)	-0.0761* (0.0539)	0.0997** (0.0115)	0.2894*** (0.0001)	-0.0187 (0.6364)	0.0086 (0.8270)	0.2428*** (0.0001)			
EBIT to asset	0.0063 (0.8743)	-0.0163 (0.6799)	0.2950*** (0.0001)	0.1115*** (0.0047)	0.0554 (0.1608)	0.5368*** (0.0001)	0.2616*** (0.0001)	0.0772* (0.0507)	-0.0942** (0.0169)		
Operation risk	-0.0397 (0.3152)	-0.0605 (0.1258)	-0.0327 (0.4082)	0.0377 (0.3403)	0.0192 (0.6272)	-0.0973** (0.0137)	-0.1227*** (0.0018)	-0.0074 (0.8517)	0.0416 (0.2925)	-0.1662*** (0.0001)	
corporate governance score	-0.2790*** (0.0001)	0.0297 (0.4531)	0.3299*** (0.0001)	0.0692* (0.0797)	0.2572*** (0.0001)	0.2101*** (0.0001)	0.1477*** (0.0002)	0.5246*** (0.0001)	0.1089*** (0.0057)	0.1999 (0.0001)	-0.0182 (0.6461)

Table 3. Inside Ownership and Corporate Governance Scores (3-year panel data analysis)

The sample includes 217 non-financial firms listed on the Korea Stock Exchange during the period. The dependent variable is the categorized corporate governance scores of Korean firms over the 3-year period between 2001 and 2003, and we use the random effect model for the control of firm-specific effects. The numbers in parentheses are t-values, and ***, ** and * denote significance at the 1%, 5% and 10% levels respectively.

Specifications	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Dependent Variable	CGS	CGS	Shareholder Rights	Shareholder Rights	Composition of BOD	Composition of BOD	Operation of BOD	Operation of BOD
Constants	4.7816*** (45.87)	-2.2567*** (-3.59)	5.3921*** (65.62)	5.6855*** (8.79)	3.8061*** (21.07)	-7.3968*** (-5.74)	4.7001*** (28.49)	-4.6144*** (-4.16)
Family ownership	-1.9733*** (-6.20)	-0.8476*** (-3.01)	-1.2743*** (-5.06)	-1.4589*** (-5.05)	-3.5959*** (-6.52)	-1.5178*** (-2.62)	-2.1833*** (-4.32)	-0.3065 (-0.62)
Affiliated ownership	-0.6645** (-1.97)	-0.5793** (-2.13)	-1.8604*** (-6.90)	-1.8826*** (-6.74)	-1.3999** (-2.36)	-1.1329** (-2.02)	0.6694 (1.24)	0.7708 (1.61)
Chaebol dummy		-0.0208 (-0.19)		-0.0392 (-0.35)		-0.0892 (-0.41)		0.2229 (1.18)
Cash flow		0.5219 (0.96)		0.0124 (0.02)		1.6514 (1.38)		0.0465 (0.05)
Sales growth rate		0.7929*** (3.24)		-0.0253 (-0.10)		1.9822*** (3.80)		0.7799* (1.78)
Asset size		0.3382*** (10.77)		-0.0067 (-0.21)		0.5264*** (8.19)		0.4367*** (7.90)
Debt ratio		-0.1208 (-0.59)		-0.2914 (-1.39)		0.3629 (0.87)		0.1932 (0.54)
EBIT		1.4167** (2.05)		0.8594 (1.21)		-2.0289 (-1.38)		1.1561 (0.94)
Risk		2.3258* (1.82)		-0.9148 (-0.70)		5.8069** (2.14)		3.5388 (1.55)
R-Square	0.0573	0.2879	0.0776	0.0832	0.0626	0.2001	0.0441	0.1845

Specifications	(9)	(10)	(11)	(12)	(13)	(14)
Dependent Variable	Disclosures	Disclosures	Audit Systems	Audit Systems	Dividend	Dividend
Constants	4.7637*** (42.75)	-2.6667*** (-3.84)	4.2642*** (17.97)	-12.871*** (-9.07)	2.9926*** (13.75)	0.8951 (0.56)
Family ownership	-1.5871*** (-4.69)	-0.6396** (-2.10)	-3.1558*** (-4.38)	-0.4975 (-0.80)	0.9055 (1.38)	0.3849 (0.57)
Affiliated ownership	-0.2994 (-0.85)	-0.2046 (-0.70)	0.5822 (0.77)	0.5733 (0.95)	0.1589 (0.23)	-0.1933 (-0.30)
Chaebol dummy		-0.1690 (-1.41)		-0.0536 (-0.22)		-0.1873 (-0.67)
Cash flow		-0.2223 (-0.44)		0.6669 (0.63)		0.0786 (0.08)
Sales growth rate		0.2085 (0.86)		-0.6552 (-1.30)		0.2383 (0.49)
Asset size		0.3686 (10.60)		0.8428*** (11.87)		0.1676** (2.09)
Debt ratio		-0.3993* (-1.81)		0.1024 (0.23)		-2.0275*** (-4.15)
EBIT		2.4016*** (3.49)		-0.1997 (-0.14)		1.9009 (1.36)
Risk		3.7861*** (2.98)		3.3922 (1.29)		-6.9121** (-2.35)
R-Square	0.0354	0.2354	0.0408	0.2690	0.0032	0.0583

Table 4. Outside Ownership and Corporate Governance Scores (3-year panel data analysis)

The sample includes 217 non-financial firms listed on the Korea Stock Exchange during the period. The dependent variable is the categorized corporate governance scores of Korean firms over the 3-year period between 2001 and 2003, and we use the random effect model for the control of firm-specific effects. The numbers in parentheses are t-values, and ***, ** and * denote significance at the 1%, 5% and 10% levels respectively.

Specifications	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Dependent Variable	CGS	CGS	Shareholder Rights	Shareholder Rights	Composition of BOD	Composition of BOD	Operation of BOD	Operation of BOD
Constants	4.0818*** (9.56)	-2.767*** (-3.88)	4.7377*** (28.22)	5.3556*** (7.24)	2.4824*** (2.24)	-7.193*** (-4.95)	4.9271*** (6.51)	-5.1466*** (-4.17)
Foreign ownership	1.2086*** (4.07)	0.3651 (1.34)	0.9193*** (2.81)	0.9769*** (2.71)	2.3107*** (4.53)	1.1817** (2.46)	1.1589** (2.13)	-0.1204 (-0.23)
Institutional ownership	0.3252 (0.86)	-0.0788 (-0.23)	1.7279*** (3.62)	1.7929*** (3.65)	0.2709 (0.39)	-0.3736 (-0.58)	0.0548 (0.07)	-0.8129 (-1.13)
Foreign ownership*Chaebol dummy	1.7115*** (3.64)	0.1824 (0.43)	-0.3146 (-0.62)	-0.1456 (-0.27)	2.8716*** (3.59)	0.4458 (0.60)	2.9152*** (3.43)	0.6023 (0.74)
Institutional ownership*Chaebol dummy	-0.2922 (-0.60)	-0.4356 (-0.99)	-1.6418*** (-2.70)	-1.6135*** (-2.59)	0.9864 (1.12)	0.4032 (0.50)	1.6024* (1.65)	1.2468 (1.37)
Cash flow		0.1599 (0.47)		-0.2306 (-0.43)		0.8923 (1.32)		-0.1276 (-0.16)
Sales growth rate		0.0125 (0.07)		0.2830 (1.09)		0.2319 (0.69)		-0.4046 (-1.07)
Asset size		0.3597*** (11.50)		-0.0397 (-1.02)		0.5070*** (9.60)		0.4858*** (8.40)
Debt ratio		-0.3016* (-1.71)		0.2353 (1.06)		-0.0577 (-0.19)		-0.2414 (-0.73)
EBIT		1.5907*** (3.14)		0.5314 (0.73)		-1.2225 (-1.29)		1.4882 (1.39)
Risk		1.3566 (1.49)		-0.2593 (-0.19)		2.5685 (1.49)		1.8149 (0.88)
R-Square	0.0934	0.2992	0.0354	0.0412	0.1194	0.2718	0.0749	0.1921

Specifications	(9)	(10)	(11)	(12)	(13)	(14)
Dependent Variable	Disclosures	Disclosures	Audit Systems	Audit Systems	Dividend	Dividend
Constants	4.1248*** (26.09)	-2.6230*** (-3.57)	3.3285*** (22.41)	-13.8221*** (-9.37)	3.0625*** (9.03)	1.8991 (1.18)
Foreign ownership	1.4726*** (4.08)	0.4573 (1.31)	1.5673** (1.96)	-0.2657 (-0.37)	0.9192 (1.28)	0.0986 (0.14)
Institutional ownership	0.7015 (1.42)	0.0075 (0.02)	-0.0590 (-0.05)	-0.8943 (-0.93)	1.3116 (1.41)	1.0089 (1.10)
Foreign ownership*Chaebol dummy	1.7113*** (3.03)	0.0449 (0.08)	5.2553*** (4.15)	1.1665 (1.04)	0.5019 (0.44)	0.1596 (0.14)
Institutional ownership*Chaebol dummy	-0.0765 (-0.12)	-0.2299 (-0.39)	-0.5310 (-0.38)	-1.6784 (-1.35)	-2.1457* (-1.79)	-1.5252 (-1.31)
Cash flow		-0.5103 (-1.05)		0.6708 (0.64)		0.5824 (0.65)
Sales growth rate		0.0478 (0.20)		-0.9018* (-1.78)		0.2024 (0.43)
Asset size		0.3563*** (9.24)		0.8909*** (11.22)		0.1129 (1.34)
Debt ratio		-0.3649* (-1.66)		0.2432 (0.54)		-2.1226*** (-4.48)
EBIT		1.9373*** (2.82)		-0.0355 (-0.02)		2.5811* (1.92)
Risk		3.7205*** (2.98)		3.8889 (1.47)		-6.0626** (-2.50)
R-Square	0.0918	0.2255	0.0654	0.2663	0.0097	0.0721

CORPORATE GOVERNANCE, CONTROL TYPE, AND PERFORMANCE: THE NEW ZEALAND STORY

Jianguo Chen*, Dar-Hsin Chen*, Ping He**

Abstract

This study investigates the ownership structure of New Zealand non-financial companies in terms of both ownership and management control and examines the effect of ownership structure on corporate governance and firms' performance. The Berle and Mean's hypothesis of separation of ownership and control does not find support in New Zealand. Further analysis tests the proposition that the diffusion of corporate ownership has allowed corporate managers to pursue goals other than profit maximization. The findings do provide evidence of a non-monotonic relation between managerial shareholdings and firm performance. This result indicates the complex nature of the relationship between ownership structure and firm value.

Keywords: Corporate Governance; Ownership structure; Agency cost; Corporate Finance

* Both Jianguo Chen and Ping He are at the Department of Finance, Banking and Property at Massey University, New Zealand.

**Dar-Hsin Chen is at Department of Business Administration, National Taipei University, Taiwan.

Please address all correspondence to: Dar-Hsin Chen, Department of Business Administration, National Taipei University, 151 University Rd., San Shia, Taipei County, 237 Taiwan. Tel: 886-2-2500-9820. Fax: 886-2-2502-9353. Email: dhchen@mail.ntpu.edu.tw.

1. Introduction

The relationship between ownership structure and firm performance has been a focus of academic research as early as Berle and Mean (1932), who hypothesize that an inverse correlation should be observed between the diffuseness of shareholdings and firm performance. Given the significance of this topic in management, economics, and finance, the relationship between ownership structure and firm performance is one that has received considerable attention in the empirical studies. However, the empirical results have failed to provide consistent evidence to prove whether the type of ownership does significantly affect firm performance.

In response to these conflicting results, Demsetz and Villalonga (2001) suggest that no systematic relations should be expected between ownership structure and firm performance. This is because that optimal ownership structures are those that emerge from the interplay of market forces. Demsetz (1983) argues that ownership should be thought of as an endogenous variable and that this effect should not be ignored in empirical estimation in order to reach an unbiased conclusion. As a result, question should be raised regarding the findings of the previous studies that treat ownership structure as exogenous.

Another concern, raised by McEachern (1975), is that the majority of previous studies make no

difference between outside owners who are not actively involved in management and owners who are also managers. He further argues that by treating no difference between these two groups, the previous studies assume that controlling shareholders who are also managers have similar incentives to those shareholders who are external to the firm. By recognising the possible conflicting interests between these two groups, Demsetz and Villalonga (2001) adopt the two ownership variables, that is, the fraction of shares owned by the five top shareholding interests and the fraction of shares owned by top managers and directors of the board.

Another new development, advanced by Morck et al. (1988) and McConnell and Servaes (1990), is that consideration should be given to possibility of the existence of non-linear relationships between ownership and performance. This study has been built upon Demsetz and Villalonga (2001), who adopt two equations to account for the endogeneity concern and two measures of ownership structure for allowing for the different interests. The study also seeks to contribute to the limited evidence regarding the relationship among corporate governance, ownership structure, and firm performance in the New Zealand context, where two previous studies have failed to account for the endogeneity and multi-dimension concerns of ownership structure. Moreover, this study revisits the work of Morck et al. (1988) by running a

segmented linear regression of firm performance on managerial ownership for investigating whether our results are consistent with their findings.

The remainder of the paper is organized as follows. Section 2 reviews the related literature and Section 3 discusses the conceptual issues. Section 4 describes the employed data and models, followed by the discussion of main findings in Section 5. Finally, Section 6 concludes this paper.

2. Literature Review

Berle and Mean (1932) hypothesize that an inverse correlation should be observed between the diffuseness of shareholdings and firm performance. This is because that when shareholders are too diffuse to monitor managers, corporate resources can be used for the benefits of managers rather than for maximising shareholder wealth. In supporting the Berle and Mean's notion, managerial theorists, such as Williamson (1964), explain that the separation of ownership from control allows managers to pursue their own interests at the expense of the maximisation of shareholder wealth. Therefore, management controlled firms should be less profitable than owner controlled firms. Mosen and Downes (1965), for example, argue that large managerial firms, or diffused ownership firms, are expected to be more risk averse and experience less variability of profits than concentrated ownership firms due to the divergence of goals between owners and top management in modern capitalism.

On the other hand, opponents of this view argue that managers are effectively constrained from taking actions that are not in the best interests of shareholders. Fama (1980), for example, claims that competition in the managerial labour markets will constraint managerial discretion and the presence of external directors on the board may limit management undesirable behaviour. Jensen and Mackling (1976) show how the interests of both managers and shareholders can be aligned through increased level of management ownership and well-designed management compensation packages. Benston (1985) also draws the same conclusion regarding this matter and suggests that increasing management shareholding is an effective way to mitigate agency problems. This is because that the potential gains from stock market will be far more than management remuneration in most cases.

Considering the significance of this topic in management, as well as finance, economics and law, the relationship between the ownership structure and firm performance is also one that has received considerable attention in the empirical studies. Some studies find support for the managerial hypothesis of which owner-controlled firms are expected to earn higher rates of return than manager controlled firms. Mosen et al. (1968), for example, find that the owner-controlled group of firms outperformed the management-controlled firms by a considerable

margin through the analysis of 500 largest U. S. industrial firms between 1952 and 1963. By carrying out a study for 86 large U. K. firms during the period of 1957-1967, Radice (1971) reveals that higher profit rates and greater variability of profits are more expected to be associated with owner-controlled firms than management-controlled firms. Consistent with the previous studies, Holl (1977) also observes a significant out-performance by owner-controlled firms over management-controlled firms during a study for 343 U. S. firms.

Holl (1975), however, observes inconclusive evidence with respect to the effect of ownership and control on firm performance during a study of 183 quoted U. K. firms. Holl (1977) later suggests that one of possible reasons reconciling the conflicting evidence reported earlier is the failure of allowing for the constraint effect of market discipline upon management behaviour. Holl (1977) further argues that only these management-controlled firms, not subject to this discipline, are expected to report lower profit rates than owner-controlled firms. Kamerschen (1968) employs the type of control as one of the explanatory variables relating to firm performance among the 200 largest U. S. non-financial firms, but his finding also is not statically significant. In contrast to the studies mentioned before, there are few, which have found management-controlled firms significantly out-perform owner-controlled firms. For example, Thonet and Poensgen (1979) find that management-controlled firms are expected to earn higher return on equity.

So the empirical research on the effects of ownership structure on firm performance span several decades, however, has failed to provide consistent evidence to prove whether the type of ownership does significantly affect firm performance. Historically, empirical research has examined the impact of ownership structure on firm performance by using simple regression models. But more recently a second generation of research has been built upon an idea raised by Demsetz (1983), who argues that ownership should be thought of as an endogenous variable and that this effect should not be ignored in empirical estimation in order to reach an unbiased conclusion. Demsetz and Lehn (1985) provide evidence of the endogeneity of a firm's ownership structure and also assess the validity of the thesis forwarded by Berle and Means (1932): A linear regression of an accounting measure of profit rate on the fraction of shares owned by the five largest shareholding interest, in which ownership structure is treated as an endogenous variable, gives no evidence of a relation between ownership structure and firm performance. By re-examining this relationship Demsetz and Villalonga (2001) provide further evidence to support the view that optimal ownership structures are those that emerge from the interplay of market forces. Consequently, they argue that no systematic relation should be expected between ownership structure and firm performance.

In support of the endogeneity concern raised by Demsetz and Lehn (1985), Cho (1998) provided further evidence that firm value affects ownership structure by estimating a simultaneous equation regression instead of OLS. As a result, he argues that ownership structure is endogenously determined, and in turn, question should be raised regarding the findings of the previous studies that treat ownership structure as exogenous. Several recent studies have also analysed the impact of managerial ownership on firm performance. Morck et al. (1988) and McConnell and Servaes (1990) argue that the relationship between management ownership and firm performance is non-linear. Based on the findings of Morck et al. (1988), there is a positive relationship between management ownership and Tobin's Q in the 0% to 5% ownership range, a negative relationship in the 5% to 25% range, and a positive relationship beyond the 25% ownership level. In terms of these findings, Morck et al. (1988) interpret that managerial ownership at low levels provides effective means to align conflicting goals between shareholders and management, whereas management becomes entrenched and can indulge in non-value-maximizing activities at high levels of managerial ownership.

Fogelbery (1980), the first to consider the relationship between ownership and control in New Zealand, suggests that New Zealand has experienced a substantial movement towards management control, because it is beyond the resources of any individual or small group of shareholders to manage a company once the company reaches a certain size. Given the growing separation of ownership and management of companies in New Zealand, the question of how the changing pattern of ownership affects firm performance has become popular. Little evidence to our knowledge, however, is available for the New Zealand markets, while a number of studies, although contradictory, are available for the U. S. and the U. K. markets. There are, however, only two previous studies have examined impacts of ownership structure on firm performance of New Zealand listed companies. The first one is carried out by Firth (1986), who classifies companies as either owner-managed or owner-controlled. Firth (1992) finds no evidence of significant relationship between control-type and accounting figures based measures of profitability. He further argues that the result supports the view that as long as strong monitoring and incentive schemes have been imposed upon firm management, firm performance is not necessarily dependent on ownership structure. Fox (1996) also concludes that ownership of New Zealand public companies does not appear to influence firm performance by measuring ownership as the proportion of issued voting capital held by the major largest shareholder. In support of the Firth's view, Fox (1996) further argues that the reason for this finding may lie in the nature of ownership structure of New Zealand listed companies. According to Fox (1996), New Zealand companies have become more

majority controlled and less management controlled since 1962. Consequently, little scope has been left for management to pursue activities which are not in the best interests of shareholders. In other words, major shareholders have enough power to discipline the management, who do pursue such self-interested behaviour. Although the same conclusion has been reached by these two previous studies in examining the relationship between ownership structure and firm performance, the reliability of their results could be challenged by the findings of Demsetz and Villalonga (2001), who argue that ownership structure is endogenous. Their arguments imply that the findings (Firth, 1992; Fox 1996) are bound to yield biased regression estimates by failing to take into account the impact of endogeneity when seeking to ascertain the relationship between ownership and performance. Another potential problem associated with the Firth and Fox's findings is the failure to distinguish between outside owners who were not actively involved in management and owners who were also managers.

3. Conceptual and Measurement Issues

3.1 Ownership Structure

One of the main issues to the study of the effects of ownership structure on firm performance has been the classification of firms by control type. The majority of previous studies, such as Monsen et al. (1968) and Boudreaux (1973), differentiate between owner-controlled (OC) firms and management-controlled (MC) firms in terms of different criteria of ownership percentage (Short, 1994). Owner-controlled firms are those where a dominant shareholding interest exists, while management-controlled firms include those in which ownership is so widely distributed that no one individual or group has an interest that is large enough to allow them to exert a dominant influence.

In the previous studies, varying cut-off points are used to distinguish between OC and MC firms. Little consensus with regard to the ownership level at which there is effective control of the firm has been reached (Short, 1994). This arbitrary nature of measuring ownership structure impairs the reliability of their findings. Another concern associated with these studies is the failure to examine the identification of shareholders. Specifically, McEachern (1975) argues that OC firms should be further categorised into two groups in order to distinguish between outside owners who are not actively involved in management and owners who are also managers. He further argues that by treating no difference between these two groups, the previous studies assume that controlling shareholders who are also managers have similar incentives to those shareholders who are external to the firm. The problem associated with this view is that the owner managers may behave the same way as any other professional managers. As mentioned earlier, both studies (Morck et al., 1988; McConnell and Servaes, 1990), which find a non-linear relationship

between firm performance and managerial ownership also supports McEachern's (1975) argument that external shareholders and owner-managers should be assumed to have similar incentives to maximize shareholder value.

This paper will adopt the two ownership variables used by Demsetz and Villalonga (2001). These two variables are the fraction of shares owned by the five top shareholding interests (TOP5) and the fraction of shares owned by top management and directors of board (MH). By distinguishing ownership between top shareholders and the board, Demsetz and Villalonga (2001) recognise the potential diverging interests between them. Furthermore, using continuous variables rather than many control-classification schemes, which arbitrarily choose cut-off points for control type, will enhance the reliability of our findings. As Demsetz and Villalonga (2001) describe, by using these two measures to account for the complexity of interests, a study should give a more accurate result in terms of the relationship between ownership structure and firms performance.

The passage of the 1993 Companies Act in New Zealand provides a unique opportunity to study the efficacy of board oversight, and also makes this study possible. Under the 1993 Act, name, remuneration and interest of each director are compulsory disclosures in annual report. Directors' share dealings are also required to be disclosed in each report.

3.2 Endogeneity issues

While Morck et al. (1988) and McConnell and Servaes (1990) derive their conclusions regarding the relationship between ownership structure and firm performance by treating ownership structure as exogenous variable, Demsetz and Lehn (1985) show that ownership structure is endogenous and argue that due to insider information and performance compensation, ownership structure is as likely to be affected by firm performance as ownership structure is to affect performance. Their findings, ownership structure is endogenous, imply that any study with regards to relationship between ownership structure and firm performance is bound to yield biased regression estimates if they fail to account for this endogeneity. Consistent with Demsetz and Lehn (1985), Cho (1998) also finds that management ownership is a function of market value of equity and industry type. Furthermore, his findings showed that firm value, measured by Tobin's Q, is an important determinant of the management ownership. Based on the findings, Cho (1998) casts doubt upon the results in previous studies, such as Morck et al. (1988), who treat ownership structure as exogenous. In addition, Himmelbery et al. (1999) also recognize the endogeneity of managerial ownership in their study. They further explain that managerial equity stakes are an important and well-known mechanism to align the incentives of management and shareholders, and in turn this contracting environment has important

implications for econometric models designed to test the relationship between ownership structure and firm performance.

3.3 Firm performance and control variables

Two measures of performance are collected to value firm profitability: Proxy Tobin's Q and accounting-based return on equity (ROE). The Q-ratio, calculated from dividing the market value of equity by the net tangible assets attributable to shareholders, is a common measure of efficiency and future opportunities of company. According to Demsetz and Villalonga (2001), these two measures differ in two respects. First, accounting-based profit measure (ROE) is backward-looking whilst forward-looking for Tobin's Q. Another difference is that accounting profit only partially involves estimates of future events in the form of depreciation and amortization. The Tobin's Q, however, is greatly influenced by a wide range of unstable factors, such as, investor psychology, and market forecasts. Considering the above concerns, we use both measures to evaluate firm performance.

In addition to the variables mentioned above, the following control variables have been chosen for this study. Firm size, measured as the natural logarithm of total assets, is included to account for the possibility that firm performance and ownership are related through the size of the firm. Firm growth, measured as sales growth, is used to allow for life-cycle effects. Financial leverage, measured as the ratio of shareholders' equity against capital employed, is adopted to take into account the possible influence of a firm's capital structure upon its investment decisions. (Harris & Raviv, 1991). Finally, same as Demsetz and Villalonga (2001), two measures of financial risk have been included in this research: market risk (MR), or beta, measured by a regression of the monthly return on a stock on a market return index, and firm specific risk (FSR) measured as standard error of estimate from the regression. This is because based on the capital asset pricing model (Fama and Miller, 1972), investors in high beta shares seek compensation for risk in a high-expected rate of return. Therefore, both MR and FSR are included as control variables since they are likely to influence behaviour in different ways. Thus, the following variables are used in this study:

- 1) Firm value: measured by Proxy Tobin's Q and accounting-based ROE;
- 2) Ownership structure: measured by the fraction of shares owned by the five top shareholding interests (TOP5) and the fraction of shares, not including options, held by top management and directors of the board (MH);
- 3) Size: natural logarithm of booking total assets;
- 4) Growth: percentage growth rate of annual sales;
- 5) Leverage: ratio of shareholders' equity against book values of assets;

- 6) Market risk (MR): measured by β coefficient obtained through running a regression of the monthly return on a stock on monthly market return index;
- 7) Firm specific risk (FSR): measured as standard error of β estimate from the regression.

4. Data and Models

4.1 Description of data

The sample utilized in this research comprises all companies listed on the New Zealand Stock Exchange (NZSE) during the period of 2000-2003, excluding the newly listed firms during this period. Financial institutions, property, and mining companies are excluded from this study due to their unusual characteristics of balance sheet. Finally, data are collected for a total of 80 firms for 2000, 72 firms for 2001, 68 firms for 2002, and 63 firms for 2003, which all required information is available. For a further analysis, the firms are divided into three general categories: industrial firms, agriculture and forestry firms, and service firms. Accounting information, including ownership data, has been collected from DATEX database, whereas share price of listed companies downloaded from the Datastream. The measures for market risk (beta) and firm specific risk (standard error) have been calculated by running a regression of the monthly return on a stock on the monthly market return index.

4.2 OLS Regression Model

As mentioned earlier, a common approach for estimating the impact of ownership structure on firm value is based on the use of OLS analysis. Thus, the OLS regression model is discussed first. This study uses the following OLS regression models to test whether ownership structure affects firm value.

$$1) \quad Q = \alpha + \beta_1 \text{TOP5} + \beta_2 \text{MH} + \beta_3 \text{Ln}(\text{SIZE}) + \beta_4 \text{GROWTH} + \beta_5 \text{LEVERAGE}; \text{ or}$$

$$\text{ROE} = \alpha + \beta_1 \text{TOP5} + \beta_2 \text{MH} + \beta_3 \text{Ln}(\text{SIZE}) + \beta_4 \text{GROWTH} + \beta_5 \text{LEVERAGE};$$

$$2) \quad \text{MH} = \alpha + \beta_1 \text{Q} + \beta_2 \text{Ln}(\text{SIZE}) + \beta_3 \text{LEVERAGE} + \beta_4 \text{MR} + \beta_5 \text{FSR}; \text{ or}$$

$$\text{MH} = \alpha + \beta_1 \text{ROE} + \beta_2 \text{Ln}(\text{SIZE}) + \beta_3 \text{LEVERAGE} + \beta_4 \text{MR} + \beta_5 \text{FSR}$$

Note:

- Q: Proxy Tobin's Q, calculated as the market value of equity divided by the book value of net tangible assets attributable to shareholders;
- ROE: return on equity, measured as the pre-tax profit divided by the market value of equity;
- TOP5: the fraction of shares owned by the five top shareholding interests;
- MH: the fraction of shares, excluding options, owned by the directors of board;
- Ln(SIZE): natural logarithm of booking total assets;
- GROWTH: percentage growth rate of annual sales;
- LEVERAGE: measured as the ratio of shareholdings' equity (market value) against book values of assets;

- MR: market risk, measured by β coefficient obtained through running a regression of the monthly return on a stock on monthly market return index;
- FSR: Firm specific risk, measured as standard error of β estimate from the regression.

4.3 2SLS Regression Model

One of key assumptions of OLS regression is the recursivity assumption. That is, the model should not involve feedback loops. Thus, for instance, the model should not contain a situation such as one where researchers must assume that the disturbance term of the dependent variable is correlated with the causes of the independent variables. In this study, if some determinants of firm value are also determinants of ownership structure, then ownership structure might spuriously appear to be a determinant of firm value. Thus, two-stage least squares regression (2SLS) is used to cover this situation where ordinary least squares (OLS) regression's assumption of recursivity cannot be reasonably held. The econometric model advanced by Demsetz and Villalonga (2001) comprises two equations. This study has adopted the following two equations to analyze the relationship between ownership structure and firm performance in order to account for the endogeneity effect.

$$1) \quad Q = \alpha + \beta_1 \text{TOP5} + \beta_2 \text{MH} + \beta_3 \text{Ln}(\text{SIZE}) + \beta_4 \text{GROWTH} + \beta_5 \text{LEVERAGE}; \text{ or}$$

$$\text{ROE} = \alpha + \beta_1 \text{TOP5} + \beta_2 \text{MH} + \beta_3 \text{Ln}(\text{SIZE}) + \beta_4 \text{GROWTH} + \beta_5 \text{LEVERAGE}$$

$$2) \quad \text{MH} = \alpha + \beta_1 \text{Q} + \beta_2 \text{Ln}(\text{SIZE}) + \beta_3 \text{LEVERAGE} + \beta_4 \text{MR} + \beta_5 \text{FSR}; \text{ or}$$

$$\text{MH} = \alpha + \beta_1 \text{ROE} + \beta_2 \text{Ln}(\text{SIZE}) + \beta_3 \text{LEVERAGE} + \beta_4 \text{MR} + \beta_5 \text{FSR};$$

$$3) \quad \text{TOP5} = \alpha + \beta_1 \text{Q} + \beta_2 \text{Ln}(\text{SIZE}) + \beta_3 \text{LEVERAGE} + \beta_4 \text{MR} + \beta_5 \text{FSR}; \text{ or}$$

$$\text{TOP5} = \alpha + \beta_1 \text{ROE} + \beta_2 \text{Ln}(\text{SIZE}) + \beta_3 \text{LEVERAGE} + \beta_4 \text{MR} + \beta_5 \text{FSR}$$

Note:

- Q: Proxy Tobin's Q, calculated as the market value of equity divided by the book value of net tangible assets attributable to shareholders;
- ROE: return on equity, measured as the pre-tax profit divided by the market value of equity;
- TOP5: the fraction of shares owned by the five top shareholding interests;
- MH: the fraction of shares, excluding options, owned by the directors of board;
- Ln(SIZE): natural logarithm of booking total assets;
- GROWTH: percentage growth rate of annual sales;
- LEVERAGE: measured as the ratio of shareholdings' equity (market value) against book values of assets;
- MR: market risk, measured by β coefficient obtained through running a regression of the monthly return on a stock on monthly market return index;
- FSR: Firm specific risk, measured as standard error of β estimate from the regression.

5. Empirical Results

5.1 Firm Characteristics

Tables 1-4 contain the summary statistics for the whole sample and the three sub-samples. Considering the potential influence of outliers, observations with extreme values have been excluded from this study. As a result, there are a total of 261 observations available for the following analysis. Table 1 shows that the average level of managerial ownership is about 18% for 261 observations. Figure 1 depicts that there are 134 out of the 261 observations with managerial ownership level not more than 5%. That is, in 134 observations, comprising 51% of the sample population, top management own not more than 5% of the firm. The sample distributions are skewed towards low levels of managerial ownership. The managerial shareholdings, however, do span a wide range of ownership levels. In 115 observations, accounting for 44% of the whole population, board members own more than 10% of the firm.

5.2 Correlations

Table 5 presents the correlation matrix among the variables employed in this study. It is not surprising to see that Tobin's Q is positively correlated with ROE. The positive relation between Tobin's Q, or ROE, and managerial ownership seems to indicate the improved performance with the increasing managerial ownership. There is also a positive relation between Tobin's Q, or ROE, and TOP5, another measure of ownership structure. However, an only simple correlation matrix is not enough to give any conclusion regarding the complex nature of ownership structure and firm performance. Managerial shareholdings are negatively related with Ln(assets), the book value of total assets. Ln(assets) is negatively related with equity ration. These findings are reasonable. We can expect that it is more difficult for management to own significant fraction of shares in a bigger firm than a smaller firm, while a bigger firm with more tangible assets has more debt capacity for borrowing, compared with a smaller firm. None of remaining variables in the matrix are correlated to an extent to which mention is deserved.

5.3 Regression Results

5.3.1 OLS Regression Results

Results, based on Tables 6 and 7, show that firm performance, measured by Tobin's Q and ROE, is always statistically dependent on at least one measure of ownership structure by using OLS regression model, and vice versa. This result is inconsistent with the previous findings in New Zealand. In the previous studies, Firth (1992) and Fox (1996) report that there is no evidence of significant relationship between ownership structure and firm performance. This result, however, is partly consistent with Demsetz and Villalonga (2001), who find that firm performance is

always statistically dependent on at least one of the two ownership measures, but the reverse is not true.

5.3.2 2SLS Regression Results

Also based on the Tables 6 and 7, the results show that none of the two measures of ownership structure is statistically significant in the explanation of firm performance, measured as Tobin's Q and ROE. This finding is consistent with Demsetz and Villalonga (2001), who argue that no systematic relations should be observed between ownership structure and firm performance if endogeneity issue is considered, since optimal ownership structure are those that emerge from the interplay of market forces. Moreover, this finding provides evidence of the existence of endogeneity issue in the New Zealand context.

Examination of Tables 5 and 6 also reveal that, respective of the performance measure used and models adopted, there is a strongly negative relationship between managerial shareholdings and size variable. This is consistent with the view that it is harder for top management to acquire controlling shareholdings in big firms than small firms.

The next point is to test which measure of ownership structure is likely to be more strongly endogenous. After examining the Tables 8 and 9, we find that both two measures of firm performance, Tobin's Q and ROE, have a stronger influence upon TOP5 than that of upon MH. This result is inconsistent with Demsetz and Villalonga (2001), who found that management shareholdings were more strongly affected by firm performance than TOP5, measure of outside ownership structure. It is, however, difficult to find a reasonable explanation for this finding. Another point deserved to mention is that MR, measured by β , consistently relates negatively to ownership structure. This is consistent with the idea raised by Demsetz and Villalonga (2001) that variation in risk could cause variation on ownership structure.

5.3.3 Piecewise Regressions

We then investigate the break points, found by Morck et al. (1988), for determining whether our findings are consistent with their results. A segmented linear regression of firm performance, measured by Proxy Tobin's Q, has been run upon managerial ownership and other control variables by using both OLS and 2SLS regression models. The results for the Morck et al. (1988) replication using OLS model are presented in Tables 10. It is interesting to see that our findings are completely consistent with the general tenor of Morck et al.'s hypothesis that a non-linear relationship existed between performance and managerial ownership. More specifically, there is a positive relationship between management ownership and Tobin's Q in the 0% to 5% ownership range, a negative relationship in the 5% to 25% range, and a significantly positive relationship beyond the 25% ownership level. However, a potential problem for this kind of the treatment, mentioned before, is the

ignorance of endogeneity concern of ownership structure. Once the endogeneity of ownership structure has been considered, the results based on Table 11 show that management ownership is not significant in explaining firm performance during each range of managerial shareholdings. However, our finding does provide some evidence of a non-monotonic relation. This finding is consistent with Demsetz's view that at the low levels of management ownership market discipline will force management to adhere to value maximisation, but at high levels of management ownership performance may be affected adversely. This is because that the high levels of management ownership could lead to management entrenchment.

6. Conclusion

This study is primarily motivated by relatively few evidence regarding relationship among corporate governance, ownership structure, and firm performance for the New Zealand publicly listed companies. The two previous studies, New Zealand focused, have failed to take into account the endogeneity and multi-dimension issues of ownership structure. Thus, the reliability of previous results could be seriously challenged by the findings of Demsetz and Villalonga (2001). Another concern, advanced by Morck et al. (1988) and McConnell and Servaes (1990), is that consideration should be given to possibility of the existence of non-linear relationships between ownership and performance. To our knowledge, no previous study has been carried out to investigate whether New Zealand evidence is consistent with these hypotheses, forwarded by Morck et al. (1988) and McConnell and Servaes (1990).

The results from OLS regressions indicate that firm performance is always statistically dependent on at least one measure of ownership structure by using OLS regression model, and vice versa. This result is inconsistent with the previous findings in New Zealand. After allowing for the endogeneity of ownership structure, the results show that none of the two measures of ownership structure is statistically significant in the explanation of firm performance. This finding is consistent with Demsetz and Villalonga (2001), who argue that no systematic relations should be observed between ownership structure and firm performance. Another interesting finding is that our results are completely consistent with the general tenor of Morck et al.'s hypothesis that a non-linear relationship existed between performance and managerial ownership if the endogeneity concern of ownership structure is ignored. Once the endogeneity of ownership structure has been considered, results show that management ownership is not significant in explaining firm performance during each range of managerial shareholdings. However, our findings do provide some evidence of a non-monotonic relation between ownership structure and firm performance. However, a potential problem

for this kind of the treatment, mentioned before, is the ignorance of endogeneity concern of ownership structure. Once the endogeneity of ownership structure has been considered, results show that management ownership is not significant in explaining firm performance during each range of managerial shareholdings. However, our findings do provide some evidence of a non-monotonic relation.

This study generally shows that there is no strong evidence in New Zealand to support the Berle and Means's hypotheses of which a reverse relationship exists between ownership concentration and firm performance. Our findings, however, do provide evidence of a non-monotonic relation between managerial shareholdings and firm performance. This indicates that the complex nature of the relationship between ownership structure and firm value; thus further research on how the structure of corporate governance affects firm's value is needed.

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Appendices

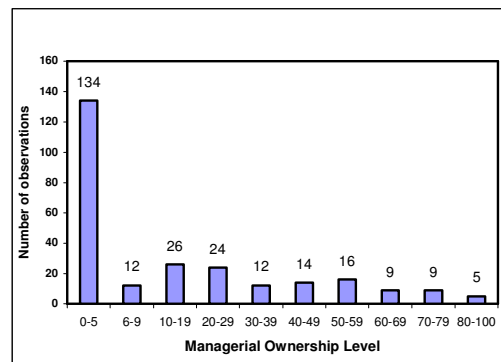


Figure 1. Managerial ownership level analysis

Table 1. Simple statistics for variables containing all firms

Variables	Mean	Std Dev	Minimum	Maximum
Q	2.81	8.82	-32.91	79.66
ROE	12.60	64.95	-217.05	847.84
TOP5	61.10	21.57	0.06	99.19
MH	18.15	24.11	0.00	91.23
Ln(SIZE)	5.31	0.88	3.23	8.25
LEVERAGE	49.83	26.97	-84.99	99.68
GROWTH	11.56	43.97	-99.53	208.17
MR	0.20	0.53	-0.54	6.54
FSR	0.03	0.02	0.00	0.10

Table 2. Simple statistics for variables containing only industrials firms

Variable	Mean	Std Dev	Minimum	Maximum
Q	3.09	9.12	-20.75	79.66
ROE	22.91	91.33	-50.21	847.84
TOP5	58.38	21.94	0.06	99.19
MH	21.39	27.03	0	91.23
Ln(SIZE)	5.21	0.87	3.23	6.64
LEVERAGE	49.79	22.39	-6.40	95.89
GROWTH	12.14	44.95	-70.84	206.49
MR	0.15	0.21	-0.38	1.19
FSR	0.03	0.02	0.00	0.10

Note: Sector classification is based on the following criteria. Industrial firms includes firms in the following classes: construction materials; building products; machinery; commercial supplies; consumer durables; health care equipment and supplies; internet software; technology hardware and equipment; textiles.

Table 3. Simple statistics for variables containing only service firms

Variable	Mean	Std Dev	Minimum	Maximum
Q	2.93	10.04	-32.91	64.29
ROE	7.09	52.75	-217.05	342.54
TOP5	64.37	21.89	6.09	95.68
MH	15.79	21.14	0	87.14
Ln(SIZE)	5.41	0.90	633.64	8.25
LEVERAGE	45.49	31.72	-84.99	99.68
GROWTH	9.60	36.23	-85.15	190.62
MR	0.28	0.748	-0.22	6.54
FSR	0.03	0.01	0.00	0.08

Note: Sector classification is based on the following criteria. Service includes firms in the following classes: restaurants and leisure; media; retailing; insurance; and consumer.

Table 4. Simple statistics for variables containing only agriculture and forestry firms

Variable	Mean	Std Dev	Minimum	Maximum
Q	2.16	4.85	0.19	32.14
ROE	7.83	24.37	-136.68	67.10
TOP5	58.54	19.63	28.62	96.70
MH	17.98	24.90	0	76.91
Ln(SIZE)	5.28	0.83	3.57	6.91
LEVERAGE	58.89	20.13	27.51	97.47
GROWTH	14.57	55.71	-99.53	208.17
MR	0.11	0.22	-0.54	0.68
FSR	0.03	0.02	0.00	0.10

Note: Sector classification is based on the following criteria. Agriculture and forestry includes firms in the following classes: agriculture; agricultural products; fishing; forestry; forest products.

Table 5. Correlation matrix

	Q	ROE	TOP5	MH	Ln(SIZE)	LEVER.	GROWTH	MR	FSR
Q	1.00000								
ROE	0.52799	1.00000							
TOP5	0.13465	0.07937	1.00000						
MH	0.12988	0.16065	0.12755	1.00000					
Ln(SIZE)	0.00351	0.05526	0.08997	-0.32947	1.00000				
LEVERAGE	-0.06117	-0.02114	0.02568	0.03128	-0.30867	1.00000			
GROWTH	0.00076	-0.01692	-0.02266	0.01131	-0.01770	-0.11043	1.00000		
MR	-0.02877	-0.00849	-0.18620	-0.08354	0.08181	-0.07755	0.00243	1.00000	
FSR	-0.14176	-0.13466	-0.03609	0.02993	-0.03859	0.00871	0.01932	0.05293	1.00000

Note: Variable definitions and sources are provided earlier.

Table 6. Comparison of OLS and OLS regression containing all firms

	Tobin's Q (OLS)	Tobin's Q (2SLS)	MH (OLS)	MH (2SLS)
Intercept	-0.47187 (-0.10)	52.42472 (0.60)	69.28550 (6.38)***	47.24462 (2.10)**
TOP5	0.04870 (1.85)*	0.204186 (0.78)		
MH	0.04445 (1.78)*	-0.74967 (-0.58)		

Table 6 continued

GROWTH	-0.00093979 (-0.07)	-0.00009 (-0.00)		
Ln(SIZE)	0.11099 (0.15)	-8.47872 (-0.60)	-9.48239 (-5.60)***	-9.30158 (-3.43)***
LEVERAGE	-0.02102 (-0.95)	-0.06374 (-0.75)	-0.06451 (-1.17)	0.025059 (0.26)
MR			-2.69220 (-1.01)	-1.54320 (-0.36)
FSR			61.39241 (0.66)	311.8365 (1.48)
Q			0.35712 (2.21)**	3.394868 (1.80)*

Note: t-statistics are in parentheses.

- * significant at the 0.10 level;
- ** significant at the 0.05 level;
- *** significant at the 0.01 level.

Table 7. Comparison of OLS and OLS regression containing all firms

	ROE (OLS)	ROE (2SLS)	MH (OLS)	MH (2SLS)
Intercept	-55.62382 (-1.68)*	350.7734 (0.53)	71.21604 (6.67)***	65.29033 (2.34)**
TOP5	0.11127 (0.58)	1.305869 (0.66)		
MH	10.55434 (3.04)***	-5.54680 (-0.56)		
GROWTH	-0.02437 (-0.26)	-0.01781 (-0.08)		
Ln(SIZE)	9.69176 (1.83)*	-56.3018 (-0.53)	-9.80592 (-5.84)***	-13.5762 (-2.59)***
LEVERAGE	-0.00557 (-0.03)	-0.33374 (-0.51)	-0.07162 (-1.31)	-0.02706 (-0.19)
MR			-2.79111 (-1.05)	-2.31844 (-0.35)
FSR			70.93892 (0.77)	516.8953 (1.06)
ROE			0.06846 (3.15)***	0.855137 (1.12)

Note: t-statistics are in parentheses.

- * significant at the 0.10 level;
- ** significant at the 0.05 level;
- *** significant at the 0.01 level.

Table 8. Comparison of management shareholdings and outside investor shareholdings in the role of endogenous ownership variable (all firms)

	MH endogenous			A5 endogenous	
	Q	MH		Q	TOP5
Intercept	52.42472 (0.60)	47.24462 (2.10)**		-1.87969 (-0.30)	20.72444 (1.01)
TOP5	0.204186 (0.78)			0.094605 (0.66)	
MH	-0.74967 (-0.58)			0.036347 (1.03)	
GROWTH	-0.00009 (-0.00)			-0.00061 (-0.05)	
Ln(SIZE)	-8.47872 (-0.60)	-9.30158 (-3.43)***		-0.10177 (-0.10)	3.856212 (1.55)
LEVERAGE	-0.06374 (-0.75)	0.025059 (0.26)		-0.02341 (-1.00)	0.103484 (1.18)

Table 8 continued

MR		-1.54320			-6.46119
		(-0.36)			(-1.66)*
FSR		311.8365			225.0190
		(1.48)			(1.18)
Q		3.394868			3.081371
		(1.80)*			(1.84)*

Note: t-statistics are in parentheses.

- * significant at the 0.10 level;
- ** significant at the 0.05 level;
- *** significant at the 0.01 level.

Table 9. Comparison of management shareholdings and outside investor shareholdings in the role of endogenous ownership variable (all firms)

	MH endogenous			A5 endogenous	
	ROE	MH		ROE	TOP5
Intercept	350.7734	65.29033		-60.9815	42.20768
	(0.53)	(2.34)**		(-1.34)	(3.21)***
TOP5	1.305869			0.285985	
	(0.66)			(0.28)	
MH	-5.54680			0.523480	
	(-0.56)			(2.04)**	
GROWTH	-0.01781			-0.02311	
	(-0.08)			(-0.25)	
Ln(SIZE)	-56.3018	-13.5762		8.882050	1.959339
	(-0.53)	(-2.59)***		(1.25)	(0.92)
LEVERAGE	-0.33374	-0.02706		-0.01466	0.044080
	(-0.51)	(-0.19)		(-0.09)	(0.65)
MR		-2.31844			-7.54043
		(-0.35)			(-2.34)**
FSR		516.8953			133.3703
		(1.06)			(1.00)
ROE		0.855137			0.283695
		(1.12)			(2.19)**

Note: t-statistics are in parentheses.

- * significant at the 0.10 level;
- ** significant at the 0.05 level;
- *** significant at the 0.01 level.

Table 10. Piecewise regressions based on OLS model

	Tobin's Q (OLS) 0%-4%	Tobin's Q (OLS) 5%-25%	Tobin's Q (OLS) >25%
Managerial Ownership			
Intercept	2.65867	6.76815	2.24288
	(0.38)	(1.09)	(0.20)
TOP5	0.07472	0.07327	-0.05402
	(2.19)	(1.60)	(-0.61)
MH	0.05104	-0.26368	0.19779
	(0.08)	(-1.93)	(2.51)
GROWTH	-0.01064	0.02150	0.00860
	(-0.54)	(1.13)	(0.38)
Ln(SIZE)	-0.50084	-1.67771	-0.05398
	(-0.50)	(-1.32)	(-0.03)
LEVERAGE	-0.04296	0.09318	-0.10179
	(-1.26)	(3.56)	(-1.67)

Note: t-statistics are in parentheses.

- * significant at the 0.10 level; 1.65
- ** significant at the 0.05 level; 1.96
- *** significant at the 0.01 level. 2.58

Table 11. Piecewise regressions based on 2SLS model

	Tobin's Q (2SLS)	Tobin's Q (2SLS)	Tobin's Q (2SLS)
Managerial Ownership	0%-4%	5%-25%	>25%
Intercept	1.846703 (0.15)	-10.6897 (-0.37)	34.88075 (0.73)
TOP5	0.074219 (2.13)	-0.01390 (-0.09)	0.623533 (0.71)
MH	0.822354 (0.09)	0.572703 (0.42)	-0.99409 (-0.65)
GROWTH	-0.01266 (-0.400)	0.020192 (0.78)	-0.03531 (-0.48)
Ln(SIZE)	-0.39165 (-0.23)	0.912258 (0.20)	-1.87780 (-0.37)
LEVERAGE	-0.04969 (-0.55)	0.015804 (0.12)	-0.19403 (-1.11)

Note: t-statistics are in parentheses.

- * significant at the 0.10 level; 1.65
- ** significant at the 0.05 level; 1.96
- *** significant at the 0.01 level. 2.58

CORPORATE GOVERNANCE AND OWNERSHIP STRUCTURE IN BRAZIL: CAUSES AND CONSEQUENCES

Pablo Rogers*, **Anamalia Borges Tannus Dami****, **Korem Cristina de Sousa Ribeiro*****,
Almir Ferreira de Sousa****

Abstract

The literature indicates that, mainly in countries with high stock concentration, the ownership structure is an important internal mechanism of control of the corporate governance, with effects in the companies' value and performance. In Brazil, the existing relationship among corporate governance - ownership structure - performance is still not conclusive. The present study investigates if there is any relationship among ownership structure, financial performance and value in the Brazilian non-financial public companies with stocks negotiated in the São Paulo Stock Exchange, between the period of 1997 to 2001, as well as the determinant of the level of concentration of the ownership in these companies. In the empiric investigation it was used a multiple regression analysis through the estimators of the Ordinary Least Squares with heteroscedasticity in accordance with White (1980). Concerning the used methodology, the results indicate that the variables of ownership structure as defined do not have influence on the financial performance and value of the companies. Remaining to the determinant of the ownership structure of the Brazilian non-financial public companies, the results indicate that the ownership structure can be explained by the size of the firm, market instability and regulation, being the latter the main determinant of the ownership structure.

Keywords: Ownership Structure, Corporate Governance, Agency Theory

* *Sao Paulo University / Federal University of Viosa, Brazil*

** *Federal University of Uberlândia, Brazil*

*** *Federal University of Uberlândia, Brazil*

**** *Sao Paulo University, Brazil*

Introduction

In countries with high stock concentration and less developed stock markets as in Latin America and special in Brazil, one of the main corporate governance issues is the agency conflict between main and minority shareholders. In accordance with Silveira (2002, p.31) "the companies' high stock concentration (share holding) and control (decision making), allied with the low legal protection of the shareholders, enables the country's main conflict of agency to be between the controlling and minority shareholders".

The stock concentration in Brazil results in an overlapping among management and ownership, and the controlling shareholders, searching for the maximization of its interests, act with opportunism expropriating the minority shareholders. In accordance with Carvalhal-da-Silva (2004, p.350):

Several researches suggest that the concentration of the right to vote on the hands of the controlling shareholders can be associated with higher degree of expropriation of the minority ones, since the controlling shareholders prefer to gain the private benefits of control, that are not shared with the minority shareholders. Thus, a greater concentration of the rights to vote on the controlling shareholders would be associated with a higher expropriation of the minority shareholders.

Analyzing a sample of 49 countries, including Brazil, La Porta *et al.* (1998) conclude that the concentration of shareholding ownership is negatively related to the protection of the shareholders rights with a consequent loss of the company's value, where countries with better legal protection tend to present a higher dispersion of the company's ownership. A later study of the same authors demonstrated that countries with less efficient mechanisms of protection of the shareholders possess a great number of companies under familiar or state control, and in the case of the familiar companies, with a high degree of separation between management and ownership (LA PORTA *et al.*, 1999).

Therein, considering La Porta *et al.* (1998 and 1999) studies, the ownership structure becomes an important mechanism of corporate governance for the companies' valuation and performance as a consequent propellant of the national stock market. In Brazil, according to Andrade and Rosseti (2004), some studies have been developed aiming at the analysis of the existing relation among corporate governance - ownership structure - performance, however, these studies considered as a set are still not conclusive, justifying researches on this relation based on new methodologies.

This research main objective is to investigate which relation exists among ownership structure, financial performance and companies' value, and which are the determinants of the stock concentration in Brazil, taking into consideration the studies of Demsetz and Lehn (1985), Pedersen and Thomsen (1997) and Siqueira (1998).

Theoretically, the study is delimited by applying a strict perspective of agency. Initially developed by Jensen and Meckling (1976), the reasoning of the Agency Theory is based on the relations between "agents" and "principals", in which the agents represent, in thesis, the interests of the principals. As there are possible conflicts of interests when the same individual has 100% of the capital of the company and accumulates the management function, the agency problem appears as the ownership begins to be split on the hands of other individuals. In this sense, the conflicts are extended by the potential of expropriation of the wealth of the minority shareholders by the controlling shareholders in a situation in which the controllers exert their power on almost the whole company.

This work is structured in five sections considering this one. In the next section it is presented the theoretical review in the perspective of the corporate governance based on the agency theory, being the ownership structure an internal mechanism of corporate governance. It intends to evidence in this section the causes and consequences of the stock concentration and its characteristic in Brazil. Section three is to show the development of the research methodology. In this section it is presented: 1) the variables operated in the study; 2) the quantitative methods adopted; and 3) the modeling adopted. In section four the results are presented on the basis of the quantitative methods adopted, adding the descriptive analysis of the variables and the limitations of the study. The last section presents the final aspects of the study.

Literature review

Demsetz and Lehn (1985) when discoursing on the subject of the ownership structure, categorize the shareholding degree of concentration into causes and consequences. The causes relate to the factors that determine the level of concentration, such as market instability, regulation of the market sector, company size and capital structure. The consequences of the level of concentration are associated to the costs and benefits for the companies' performance and value.

Causes of the Stock Concentration

Siqueira (1998, p.1) states that several researches since the eighties, considering European, North American and Asian companies, have tested the hypotheses that forces such as the degree of the sectors regulation, the size of the firm, the market instability, the company's capital structure and the

kind of controlling shareholders exert a relevant role on the level of stock concentration.

Market Regulation

Demsetz and Lehn (1985) argue that the definition of the performance rules of the companies can stimulate the reduction of the stock concentration of the property due to reduction of uncertainties. This effect can even minimize the conflict of interests between managers and controllers, widening the managers' autonomy in monitoring. Moreover, the ownership structure of companies in regulated markets also suffers from the influence of the State's high participation as a controlling shareholder.

A strong regulation of the company's sector restricts the shareholders investments options, beyond the fact that these sectors already suffer a certain monitoring by the market agents. These combined effects stimulate the reduction of the stock concentration of companies in regulated sectors.

Size of the Firm

In accordance with Siqueira (1998, p.4), the big size companies can be associated with high costs of capital and with high risk of maintenance of the level of concentration of the shareholding control – due to the risk aversion, the large companies would tend to present a low stock concentration. Demsetz and Lehn (1985, p.1,158) argue that the size of the companies varies within the sectors and among the various sectors, in such a way that as larger the company, thus depending on its position and competitiveness in its market, the greater the availability of resources, and the higher the market value of a part of its control. In accordance with Okimura (2003, p.34), this would influence the stock concentration in a reverse way, since, as higher the market value and the company's absolute value, the lower the probability and the possibility of a greater part of the control being withheld by one controlling shareholder.

Market Instability

The market instability exerts influence on the stock concentration due to the conflict of interests between managers and owners (SIQUEIRA, 1998, p.4). Thus, the conflict of interests would be lesser or bigger depending on the markets instability. The reduction of the degree of market instability (associated with changes of prices, technology and market-share) causes the reduction of the stock concentration, also being able to increase the managers' freedom for monitoring. According to Siqueira (1998, p.4),

(...) the way of measuring this effect (...) can be some measure of instability of the economic-financial performance of the companies, such as a profitability index. A high variation of the profitability during a certain period could increase the conflict among managers and owners and could cause, therefore, a change in the ownership structure (...) the level of stock concentration tends to be high in markets with high instability, with the controllers remaining, also, ahead of the businesses.

Capital Structure

The capital structure affects positively or negatively the stock concentration. The hypothesis of Pedersen and Thomsen (1997), is that the increase of the relation equity/total assets, or in another way, the increase on equity be followed by the reduction of the companies' stock concentration, mainly due to the objective of sharing the controlling shareholders' risks. Siqueira (1998, p.11) presents that the capital structure of the companies can have "(...) a positive effect on the stock concentration, indicating that, the higher the specific investments in large scale plants, the greater should be the stock concentration of the shareholding control".

Type of the Controlling Shareholder

Literature presents a classification with five types of controlling shareholders being the most relevant: 1) the controlling individual or family; 2) the institutional investor (pension funds); 3) the financial institution (banks, insurance companies, etc); 4) the government; and 5) the groups of investors (corporate holdings, companies that withhold participation in other local or foreign companies, etc). The explanation for such classification is based on the fact that the effect of the controlling shareholder in the performance of the companies can vary in accordance with the type of controller.

"The companies controlled by other foreign companies frequently present technological advantages in the business and advantages proceeding from its connection to the matrix overseas, such as cash flow, guarantees and commercial and banking relations" (OKIMURA, 2003, p.31). In addition, sometimes the foreign companies possess legal advantages and incentives to be installed in the country. In another measure, the aspect of the controller being foreign and the headquarters being in another country leads to a greater difficulty in monitoring the management, in hypothesis. Companies in other countries, like in the U.S.A. and in the United Kingdom, presents a more dispersed ownership and thus, they tend to be dispersed in the countries where they invest.

La Porta *et al* (1999) argue that for many times the familiar control places the family interests above the interests of all the other shareholders, due to the predominant voting power and involvement with the management. Such condition leads to the implementation of politics and projects that benefit the family in detriment of the corporate performance. On the other hand, the presence of a controlling family leads to a better monitoring of the management, reducing the cost of agency associated with ownership and control.

According to Okimura (2003), the financial institutions tend to prefer the liquidity of its portfolios, getting a smaller part in the control and monitoring of the management. The government as a controller plays for many times a political role with few clear and indefinite objectives.

Consequences of Stock Concentration

The existence of controlling shareholders can have deleterious effect for a company due to the possibility of the interests of the controlling shareholders not being lined up with the interests of the others shareholders (SHLEIFER and VISHNY, 1997). Moreover, the concentration of rights on the cash flows clear the path, beyond the conduction of someone's own interests inside the company, such as the nomination and destitution of managers, for the impossibility of the company to suffer a hostile take over. The controlling shareholders can expropriate the wealth of the other shareholders in several ways: 1) payments of wages in excess for itself; 2) self-nomination for privileged executive positions and positions on the board for itself or for relatives (nepotism); 3) to pay or to receive high transfer prices for their own companies; 4) transfer of shares with discount or acts of inside trading; 5) the use of company's asset as a pledge to personal transactions or to borrow funds from the company with commercial advantages; 6) propensity to the practice of under-investment, because if the investments are not recovered the costs will be divided in equal parts with all the shareholders (JENSEN and MECKLING, 1976); and 7) allocation of resources in investment projects that reduce its risks and do not maximize the company's wealth. In accordance with Andrade and Rossetti (2004, p.126), the private benefits of control can lead investors to assure themselves of returns through mechanisms that confer them the corporate control. According to the authors, the most common are:

1. Issues of shares with limited voting rights (preferred shares);
2. Cross ownership of shares of two or more companies, making it difficult the loss of control;
3. Pyramidal structure, through *holdings* that, in turn, withhold the ownership of the target companies object of control.

Claessens *et al.* (2002) summarize the costs of the stock concentration as an entrenchment effect, when the company's ownership and votes' concentration takes place (Exhibit 1). In the entrenchment effect, the increase of the share of votes and of the company's ownership withheld by the controller, lets the same to be less dependant and subject to the decisions of the board of directors and of the mergers and acquisitions market, allowing the expropriation of wealth for the private benefit, while the costs would be shared among all the shareholders (OKIMURA, 2003, p.32)

Benefits

The most important advantages related to the stock concentration are linked to the possibility of the owners to monitor the management with the probable reduction of conflicts and costs of agency. Hitt, Ireland and Hoskisson (2002, p.411) observe that,

In general, the *diffuse property* (a great number of shareholders with a small number of shares (*holdings*) and few, if existing, shareholders carrying big batches of shares) produces a weak monitoring of the management decisions. Among others problems, the diffuse property makes it difficult for the owners to coordinate its shares efficiently. A result of the weak monitoring could be a diversification of the company's product lines beyond the excellent level for the shareholders. Higher levels of monitoring could encourage the managers to prevent strategic decisions that do not create value anymore for the shareholders.

Okimura (2003, p.29) and Andrade and Rossetti (2004, p.126) point out that empirical evidences exist showing that the presence of controlling shareholders increase the monitoring benefits/costs relation, implying optimized solutions for the agency conflict issue.

La Porta *et al.* (1998 and 1999) argue that the existence of controlling shareholders is an attempt of minimizing the conflicts of agency in countries with investors' low legal and institutional protection. The main argument is that in low protection environments the only way of balancing the interests would be the existence of a controlling shareholder, what would show a signal of commitment to the external investors

that the controlling shareholders would not deviate the company's assets.

This signaling would be positive for external investors due to the fact that the valuation of the shares price is based on expectations of an *ex-post* expropriation by the controlling shareholders. If the controlling shareholders expropriate the company's cash flow, the external investors will appraise the shares with a discounting prize and consequently the controlling shareholders will have the value of its shares destroyed (OKIMURA, 2003, p.29).

Claessens *et al.* (2002) summarize the benefits of stock concentration as an alignment effect, when the company's ownership and stock concentration takes place (Exhibit 1). In the alignment effect as the amount of shares withheld by the controller increases, it increases the incentives for monitoring, at the same time as the expropriation costs also increase. At this point, the ownership of a great amount of shares brings the controller commitment of not devaluating the company's shares; therefore it would substantially reduce its wealth: such condition represents a high cost comparable to the private benefits of the minority expropriation.

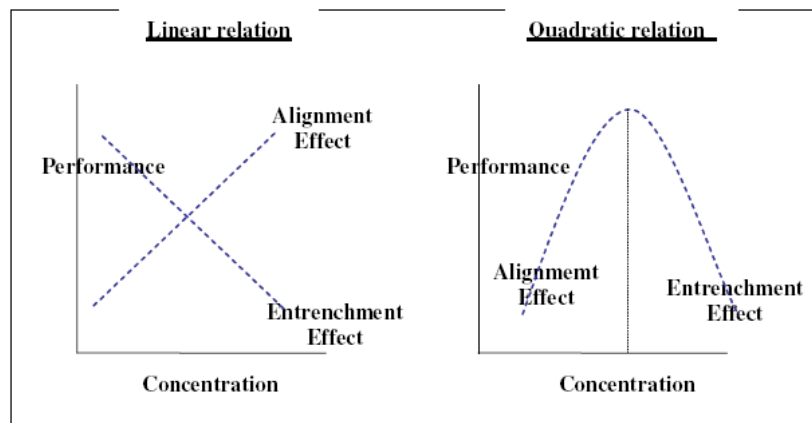


Exhibit 1. Entrenchment and Alignment Effect in the Level of Stock Concentration

Ownership Structure in Brazil

In Brazil, the ownership structure is predominantly concentrated, excessively contributing for the main conflict of agency existing in the country: between controlling and minority shareholders.

A survey realized with data from the years of 1990, 1995 and 1997 of the 100 largest non-financial companies based on its net operational revenue, in Brazil, taking into consideration Thomsen and Pedersen (1997) ownership classification, resulted that the ownership structure is concentrated and in the hands of families or foreign multinationals (SIFERT FILHO, 1998). Due to this fact, the ownership structure presents itself as the main and most studied internal mechanism of corporate governance in Brazil.

The big changes that occurred in the Brazilian economy – the opening of the local economy and privatizations – implied in changes more in the identity of the controllers than in the level of concentration (SIFERT FILHO, 1998). The privatization process in the nineties was probably the most significant event for the corporate governance in Brazil since the end of the industrialization phase. Exhibit 2 presents a summary of the studies that discuss these subjects.

Level of Concentration

Table 1 presents the results of significant samples of companies listed in the São Paulo Stock Exchange (BOVESPA), for the years of 1998 up to 2002, according to a survey carried through by Okimura, Silveira and Rocha (2004). Silveira (2002) finds

similar results for the period of 1998/2000 with data from the CVM (Brazilian Securities and Exchange Commission). The results of surveys with data from the beginning of the nineties and of the end of the century are not significantly different as to the presence of controlling shareholders (ANDRADE and ROSSETTI, 2004, p.315). According to Leal *et al.* (2000) and Carvalhal-da-Silva (2004) the companies' control is dominated on average by the three main shareholders: having kept, in accordance with Andrade and Rossetti (2004, p.315), a participation higher than 80% of the voting capital in most of the large companies.

Subjects	Empirical evidences and studies that discuss the subjects
Level of Concentration	Siqueira (1998), Valadares and Leal (2000), Leal <i>et al.</i> (2000), Carvalhal-da-Silva (2002), Saito (2002), Okimura (2003), Leal and Saito (2003), Carvalhal-da-Silva (2004), Silveira <i>et al.</i> (2004), Okimura, Silveira and Rocha (2004), Silveira, Barros and Fama (2004), Carvalhal-da-Silva and Leal (2005).
Identity of the Controllers	Siffert Filho (1998), Siqueira (1998), Rabelo and Silveira (1999), Rabelo and Coutinho (2001), Okimura (2003), Leal and Saito (2003), Carvalhal-da-Silva (2004), Okimura, Silveira and Rocha (2004)
Indirect Control	Leal <i>et al.</i> (2000), Valadares and Leal (2000), Rabelo and Coutinho (2001), Procianny (2002), Carvalhal-da-Silva (2002), Leal and Saito (2003), Carvalhal-da-Silva (2004)

Exhibit 2. Recent subjects and studies on Ownership Structure

In accordance with Table 1, the common shares kept by the controlling shareholder (or group of control) reached 76.1% in the average of 1998/2002 in relation to the total voting shares issued. Adding the preferred shares to these ones that belong to the group of control, the relation with the total of shares issued falls to 53.7%, thus evidencing, a discrepancy between the right to the ownership and to the cash flow of the company. It is still observed in Table 1, that the concentration, not only of the common shares in relation to the total shares, but also of the common shares plus the preferred ones in relation to the total shares, has lightly increased in the analyzed period.

With the year 2000's data, Carvalhal-da-Silva (2004) evidenced that 90.2% of the companies researched possessed a main shareholder and only 9.8% presented more dispersed ownership structures, but still with dominant participation of the main shareholder (Table 2). In companies with main shareholders, the main shareholder withheld 76% of the voting capital; the three main shareholders, 88%; the five main shareholders, 89%. It is also made

evident in Table 2, the high level of concentration in companies without a main shareholder: in these, the main shareholder withheld 37%; the three main shareholders, 62%; the five main shareholders, 66%.

Table 1. Level of Concentration of the Brazilian Companies

Years	Common shares of the controlling shareholder (or group of control) in relation to the total of common shares issued	Common and preferred shares of the controlling shareholder (or group of control) in relation to the total issued
1998	75.7%	52.0%
1999	75.5%	53.5%
2000	76.1%	54.0%
2001	77.3%	54.6%
2002	76.2%	54.6%
Average	76.1%	53.7%
Median	79.5%	51.5%
Standard Deviation	20.0%	24.6%

Source: Okimura, Silveira and Rocha (2004, p. 8) with adaptations.

Identity of the Controllers

Siffert Filho (1998) in a study undertaken with the 100 biggest non-financial companies in Brazil in the period of 1990/1997 evidenced: 1) the reduction in 45% of the number of state-owned companies, due to the privatization process; 2) a significant growth on the form of the dominant minority ownership control; 3) increasing participation of companies with foreign control and relative reduction of the familiar control; and 4) the dispersed and cooperative properties were not and continued not to be significant as a type of ownership structure in Brazil. Table 3 presents these observations and corroborates the author's conclusion, which affirms that the transformations evidenced during the period had contributed for a relative change of the shareholding control according to the studied typology, however the ownership structure continued concentrated.

Most recently, Okimura, Silveira and Rocha (2004) observe that the concentration possesses a dominant characteristic (Table 4): throughout the period of 1998/2002, the individual controllers or family groups represented almost half (47%) of the others owner's identities, followed by foreign private groups (23.3%). The participation of Banks, Financial Institutions (FI's) and Pension Funds remained relatively small in the period, thus observing, according to Andrade and Rossetti (2004, p.316), an asymmetry among the participation of the institutional investors and of the financial institutions in the

country's stock market and the retention of the companies' control, therefore, even so the banks and the pension funds in the period withheld, respectively, more than 50% and more than 15% of the total

applications in the Brazilian stock market, its participation as controlling categories, were of 5.2% and 0.6%.

Table 2. Direct shareholding participation of the Brazilian's company in 2000

Shareholder	Companies with Main Shareholders (203)		Companies without Main Shareholders (22)		Sample's Total (225)	
	Voting Capital	Total Capital	Voting Capital	Total Capital	Voting Capital	Total Capital
Main	76%	54%	37%	23%	72%	51%
Three Main	88%	65%	62%	41%	85%	62%
Five Main	89%	65%	66%	44%	87%	63%

Note: Average direct shareholding participation of the 225 Brazilian companies listed in the São Paulo Stock Exchange. A company with a main shareholder is the one in which a shareholder possesses 50% or more of the voting capital. Number of companies in each group between brackets.

Source: Carvalhal-da-Silva (2004, p.353).

Table 3. Ownership of the 100 larger non-financial companies in Brazil – 1990, 1995 and 1997 (percentile in the participation of the total revenues of the 100 larger companies)

	Dispersed ownership	Dominant ownership	Familiar ownership	State ownership	Foreign ownership	Cooperatives
1990	0.4%	3.5%	22.6%	44.3%	26.9%	2.3%
1995	2.1%	7.9%	17.1%	32.8%	37.9%	2.1%
1997	1.8%	12.4%	16.5%	31.8%	37.2%	0.4%

Source: Siffert Filho (1998, p.13) with adaptations.

Carvalhal-da-Silva (2004) still analyzes the shareholding structure of the Brazilian companies by group of controllers. Table 5 presents the author's results confirming other surveys: the dominant categories of controllers are family groups (48%) and foreigners (27%). In accordance with the Table, on average, institutional investors possess 80% of the voting capital, while the foreigners, the government and the families possess, respectively, 79%, 75% and 73%. In relation to the total capital, the institutional investors, the foreigners, the government and the families possess, respectively, 66%, 62%, 57% and 46%.

Indirect control

According to Rabelo and Coutinho (2001, p.15), two mechanisms strengthen the main shareholders' control of the Brazilian companies: the use of pyramids and the possibility of issuing two types of shares (preferred and common). According to the authors, the use of pyramids in the ownership structures makes it possible to control some companies even with a small part of its total capital. Rabelo and Coutinho (2001, p.15) show that more than half of the companies in Brazil that have families as controlling shareholder uses pyramids in its ownership structures.

Table 4. Ratio of controllers of the companies in Brazil, according to identity (% over the total)

	Foreign Private	Local Private	Familiar or Individual	Banks or FI's	Pension fund
1998	28.4	18.0	47.9	0.5	5.2
1999	29.5	17.9	46.8	0.5	5.3
2000	27.5	19.2	46.2	0.5	6.6
2001	26.9	18.7	46.8	0.6	7.0
2002	27.3	18.8	48.1	0.6	5.2
Average	27.9	18.5	47.1	0.6	5.8

Source: Okimura, Silveira and Rocha (2004, p.8) with adaptations.

Table 5. Shareholding participation of the several controlling groups in 2000

		Firms		Direct participation (%)		Indirect participation (%)	
		Number	%	Voting Capital	Total Capital	Voting Capital	Total Capital
Total Sample		225	100	72	51	66	38
Firms With Controlling Shareholder	Family	108	48	73	46	86	31
	Government	16	7	75	57	77	51
	Foreign	60	27	79	62	74	56
	Institutional	19	8	80	66	84	33
	Total	203	90	76	54	69	40
Firms Without Controlling Shareholding		22	10	37	23	40	24

Note: The companies that possess a controlling shareholder had been classified according to the origin of the equity (foreign, state, familiar and institutional) and each one of the shareholding structure was analyzed.

Source: Carvalho-da-Silva (2004, p.355).

In relation to the possibility of issuance of two types of shares, Rabelo and Coutinho (2001, p.16) cite four cases: families Setubal and Villela control Banco Itaú with only 8.5% of its total capital; family Moreira Salles does the same with Unibanco with 10.9% of the total capital; Odebrecht family uses pyramid and common and preferred shares to obtain the control of the petrochemical company Trikem with 10.7% of its total capital; and Gerdau S.A. is controlled with 8.3% of the total capital by the Gerdau family. The authors ponder that it is difficult to say which one of the instruments – two types of shares or pyramids – is more important for the corporate control in Brazil, the most reasonable would be to say that the combinations of the two instruments supply an efficient method for the main shareholders to guarantee the corporate control with a small percentage of the total capital (RABELO and COUTINHO, 2001, p.15-16).

However, the results of Carvalho-da-Silva (2004) point out that the possibility of the issuance of two types of shares is more important than the pyramidal structure for the main shareholders to guarantee the corporate control. Table 2 shows that, in a company with only one main shareholder, this

possesses an average of 76% of the votes, but only 54% of the total capital. Considering the entire sample, the five main shareholders possess 87% of the votes, but only 63% of the total capital. Table 6 presents the indirect structure of control and ownership of the Brazilian companies, in 2000, evidencing that, in the case of companies whose main shareholder possesses 50% of the voting capital directly, the indirect ownership is weaker.

In the direct form, the main shareholder possesses, on average, 76% of the voting capital and 54% of the total [Table 2], while indirectly the participations are, respectively, 69% and 40% [Table 6]. On the other hand, this reduction in the participation of the main shareholder does not occur in companies where a main shareholder does not exist. On the opposite, the data show a small increase in the capital invested for these cases. In the direct form, the main shareholder possesses, on average, 37% of the voting capital and 23% of the total [Table 2], while indirectly the participations are, respectively, 40% and 24% [Table 6]. This fact can indicate the use of pyramidal structures to keep the control with reduced investment in the company (CARVALHAL-DA-SILVA, 2004, p.354).

Table 6. Indirect shareholding participation of the Brazilian companies in 2000

Shareholder	Company With Main Shareholder (203)		Company Without Main Shareholder (22)		Total of the Sample (225)	
	Voting Capital	Total Capital	Voting Capital	Total Capital	Voting Capital	Total Capital
Main	69%	40%	40%	24%	66%	38%
Three Main	83%	51%	61%	39%	81%	50%
Five Main	85%	54%	64%	41%	83%	52%

Note: Average indirect shareholding participation of the 225 Brazilian companies listed in the São Paulo Stock Exchange. A company with a main shareholder is that one in which a shareholder possesses 50% or more of the voting capital. Number of companies of each group among brackets.

Source: Carvalho-da-Silva (2004, p.354) with adaptations.

Thus, it is presented that the use of pyramidal structure does not seem to be an effort to prevent the rule “one share - one vote” in Brazilian companies. Although the Brazilian legislation accepts the possibility of having a direct control of the company with 17% of the total direct capital, it is not this that Table 6 shows: the main shareholder indirect participation in the total capital, when it keeps the control indirectly, is on average 43% and 16% when it does not keep the control; the participation in the voting capital is also higher than 50% in most part of the cases, even indirectly.

Table 7 shows the presence of shareholders agreements, pyramids structures and percentage of common shares in the total capital of the company per controlling group. According to Carvalho-da-Silva (2004, p.354), these three mechanisms are closely connected to the ownership structure and control and with the possibility of expropriation of the minority stockholders, “since they can magnify the separation between the right to vote and the cash flow”. It is evidenced in the table that most of the companies (86%) possess pyramidal structures, that tend to be less used in state-owned companies (63%) and more used in familiar (91%) and foreign companies (87%).

Table 7. Mechanisms of separation between control and ownership in Brazil (%)

		Companies with Shareholder Agreements	Companies with Pyramid	Common Shares in the Total Capital
Total sample		23	86	53
Firms with Controlling Shareholder	Family	27	91	49
	Government	6	63	64
	Foreign	28	87	56
	Institutional	21	79	51
	Total	23	86	53
Firms Without Controlling Shareholder		27	82	59

Note: The company that possesses a controlling interest had been classified according to the capital's origin (foreign, state, familiar and institutional) and it was analyzed the presence of three mechanisms of control and ownership separation: agreement of shareholders, pyramids and percentage of common shares in the total capital.

Source: Carvalho-da-Silva (2004, p.355).

It is concluded, in accordance with the empirical evidences described, that despite the opening of the economy and the privatizations occurred in Brazil, in the nineties, had significantly changed the identity of the controllers, the ownership remains concentrated in the hands of family and foreign groups, being dominated on average by the three main shareholders. Another relevant aspect of the ownership structure refers to the fact that mechanisms such as the use of pyramids and the possibility of issuance of two types of shares (common and preferred) strengthen the degree of concentration in Brazil.

Research Methodology

Variable Definition

3.2.1 Ownership Structure and Control

In accordance with Okimura (2003, p.44), there is not yet in the academic literature a consensus about the choice of measures of ownership structure and control for the analysis of the companies' value and performance. The choice of the appropriate measure, in accordance with the author, depends on the availability of data and its adequacy to the applicability of the study.

According to Okimura, Silveira and Rocha (2004, p.3), the researches that aim at analyzing the impact of the stock concentration tend to use the Herfindahl index (HCON), that is, the sum of the main shareholders participation in the company's voting shares (usually the 5 main). Demsetz and Lehn (1985, p.1163) and Demsetz and Vilalonga (2001, p.218) suggest a logistic transformation of this measure in order to convert discrete values into continuous ones. The authors, who study the ownership concentration in developing countries, as do Okimura (2003), Okimura, Silveira and Rocha (2004) and Siqueira (1998), in Brazil, tend to directly use only the main shareholding stock concentration as a percentile.

In this research, further than this variable, other three were defined:

- Voting concentration or right of control concentration (CON), defined in accordance with equation 1:

$$CON = \frac{P_i}{P} \times 100 \quad [1]$$

Where, P_i is the number of common shares of a company i belonging to the main shareholder and, P represents the total amount of common shares of the considered company.

- Voting concentration or right of control concentration of the three main shareholders (CON3), defined in accordance with equation 2:

$$\text{CON3} = \sum_{i=1}^3 \left(\frac{P_i}{P} \times 100 \right) \quad [2]$$

Where, P_i and P are defined as in variable CON.

An observation about this variable is important since the study consider only the three main shareholders instead of five as it is most commonly used (OKIMURA, 2003, p.44). The fact of considering only the three main shareholders is justified therefore Carvalhal-da-Silva (2004, p.353) and Leal *et al.* (2000, p.6) emphasize that the Brazilian companies are controlled, on average, by its three main shareholders, being that in the research carried through by the authors above cited average participations of 85% and 79% of the three main shareholders were found, respectively.

- Herfindahl Index of the sum of the parcel of common shares withheld by the three main shareholders (HCON), defined in accordance with equation 3:

$$\text{HCON} = \sum_{i=1}^3 \left(\frac{P_i}{P} \times 100 \right)^2 \quad [3]$$

Where, P_i and P are defined as in variable CON.

This index has the advantage of giving more weight to the companies who possess higher concentration. The value of HCON is maximized when the participation of one only shareholder represents 100% of the ownership of the company and in these terms $\text{HCON} = 10,000$. When the shareholders have egalitarian participation, the index assume the lesser value, $\text{HCON} = 10,000/n$ ($n=3$).

- Entropy Coefficient of the participation of the company's three main shareholders (CE), defined in accordance with equation 4:

$$\text{CE} = \sum_{i=1}^3 P_i \times \log \frac{1}{P_i} \quad [4]$$

Where, P_i is defined as in variable CON.

When there is only one shareholder, $\text{CE} = 0$; when all the shareholders present equal participation in the company's ownership, the entropy is maximized and $\text{CE} = \log N$. In this study the value of CE is maximized when $\text{CE} = \log 3 \cong 0.47712$.

Further to these control and ownership variables, it was also considered the kind of controlling shareholder, defined as:

- Type of controlling shareholder (TCON), as considered by Siqueira (1998). This variable assumes the dichotomy form (*dummy*) being that:
 - TCON = 0, if the company is controlled by foreign groups; and
 - TCON = 1, if the company is controlled by Brazilian individuals or groups.

Performance and Company Value

The metrics used to assess the companies' financial performance are not yet unanimous in the academy. Amongst those that are most adopted, in accordance with Barney (1997), four categories can be highlighted: a) the survival (as a cash flow measure); b) the accounting indexes of performance; c) the measures of value creation for the *stakeholders* and; d) the measures of net present value. In the research, it was considered one of each measure of groups b and c.

As a performance measure by accounting indexes (related with the ownership structure) it was used, as did Demsetz and Lehn (1985) and Siqueira (1998), the equity profitability (RPL) defined in accordance with equation 5:

$$\text{RPL}_i = \frac{\text{LL}_i}{\text{PL}_i} \quad [5]$$

Where, LL_i is the net profit of company i and PL_i express the accounting value of the equity of company i .

As a measure of value creation for the shareholders it was prioritized the Tobin's q ratio (Q), as defined in accordance with equation 6:

$$Q = \left(\frac{\text{VMO} + \text{VMAP} + \text{DIVT}}{\text{AT}} \right) \quad [6]$$

Where, VMO = market value of the common shares; VMAP = market value of the preferred shares; DIVT = short and long term debt accounting value less current assets, after the exclusion of the supplies value; and AT = accounting value of the total assets.

This measure is defined by Chung and Pruit (1994, p.72) and discussed by Famá and Barros (2000) as an approach of what was initially considered by Tobin and Brainard (1968) *apud* Okimura (2003, p.47).

The essence of this equation is that the replacement costs are a reasonable measure for the values of alternative uses of the assets; therefore the companies' value by this index is defined as the ratio between the market value of the shares and debts by the replacement cost of the assets (OKIMURA, 2003, p.47).

Some recent empirical studies that relate the ownership structure and control with the performance of the companies in the world and in Brazil use the Tobin's q , such as: Demsetz and Vilalunga (2001), Leal *et al.* (2000), Okimura (2003), Carvalhal-da-Silva (2004), Okimura, Silveira and Rocha (2004), Silveira (2004), Silveira *et al.* (2004), Carvalhal-da-Silva and Leal (2005), and Silveira, Barros and Famá (2005).

Other variables

The size of the firm

The company size is defined as the nominal accounting value of the total assets (AT) as used by Demsetz and Lehn (1985), Pedersen and Thomsen (1997), Demsetz and Vilalonga (2001) and Siqueira (1998). Demsetz and Lehn (1985), Pedersen and Thomsen (1997) and Demsetz and Vilalonga (2001) identified a negative effect of the size of the firm on the level of concentration of the shareholding control, that is, according to both studies the increase of the size of the firm provides a greater dispersion of the shareholding control. However, for Brazil, Siqueira (1998) found a positive relation between the company size and level of concentration of the shareholding control.

The instability in the profitability

It was used as a *proxy* of the instability in the profitability, the standard deviation of the equity profitability (INST) for the period in analysis. This *proxy* was also used by Demsetz and Lehn (1985), Pedersen and Thomsen (1997), Demsetz and Vilalonga (2001) and Siqueira (1998). In Brazil, Siqueira (1998) did not find a significant statistical relation between this variable and the concentration of the shareholding control diversely from the results found by Demsetz and Lehn (1985) and Pedersen and Thomsen (1997), which identified a positive correlation between the instability in the profitability and the ownership concentration, that is, the increase of the instability generates an increase on the concentration of the ownership control.

Capital Structure

This variable is used in the models developed by Siqueira (1998) for the Brazilian economy. The capital structure (ESTCAP) is defined in accordance with equation 7:

$$ESTCAP = \frac{PL_i}{AT_i} \quad [7]$$

Where, PL = accounting value of the equity of a company i; and AT = accounting value of the total assets of a company i.

Demsetz and Vilalonga (2001), Okimura (2003), Okimura, Silveira and Rocha (2004), Silveira (2004) and Silveira, Barros and Famá (2005) make use of this control variable to study the relations between performance and governance structures, however, consider as *proxy* the value of the debts over the total asset (leverage) what it is equivalent approximately, to one less variable ESTCAP considered by Siqueira (1998) and herein prioritized.

Net revenue

This control variable is defined as the average growth rate of the net revenue for the considered period, in nominal Real (equation 8):

$$CRL = \frac{Vendas_{i+1} - Vendas_i}{Vendas_i} \quad [8]$$

Capital intensity

The *proxy* of the capital intensity (INTCAP) as a control variable is included in the agreement research as in Demsetz and Vilalonga (2001) and Siqueira (1998), being that this one is measured in equation 9:

$$INTCAP = \frac{AT_i}{RL_i} \quad [9]$$

Where, RL = value of the net revenue of a company i; and AT = accounting value of the total assets of a company i.

Market regulation

Demsetz and Lehn (1985) and Siqueira (1998) identified that utility companies (UTIL) presented strong statistical significance in relation to the concentration of the shareholding control. The first authors found a negative relation while Siqueira (1998) found a positive relation for these two variables in Brazil. The UTIL variable in the research assumes the dichotomy form in which utility companies = 1 and the other companies = 0. The public utility companies in the research comprise those of the telecommunications, energy and gas sector.

Sampling and Data Collection

In May 2001, there were 459 companies listed in the São Paulo's Stock Exchange (BOVESPA), 289 had data available in the Economática®'s data base. For the development of the study, it were considered all the public non-financial companies with stocks negotiated in the São Paulo Stock Exchange, with available data for, at least three of the five studied years (1997 until 2001), resulting in a total of 176 companies. The non use of the data of the financial companies comes from the fact that these companies present a bias historically evidenced of better performance in comparison to the non-financial companies.

For the variables of ownership structure and performance and the other *dummy* variables, it were considered its positions in the last year of study as the methodology developed by Demsetz and Lehn (1985) and Siqueira (1998). That is, variables CON, CON3, HCON, CE, TCON and UTIL assumed the value of the year 2001. Also as proposed by Demsetz and Lehn (1985) and Siqueira (1998), for the other variables: RPL, Q, AT, INST, ESTCAP, CRL and INTCAP; it were considered the average of the available observations for the period of 1997 until 2001.

Modeling and Statistical Method Adopted

This study aims at answering the issues referring to the determinants of the level of concentration of the shareholding control of the non-financial public companies negotiated in the SÃO PAULO STOCK EXCHANGE and its respective impacts on the companies' financial performance and value. Considering dependant the performance variables one searches to verify if the same ones suffer a linear and/or quadratic influence from the concentration of the shareholding control (entrenchment and/or alignment effect). Thus, the empirical models to be estimated can be written in the form of equation 10 and alternatively in the form of equation 11:

$$Y_i = \beta_1 X_i + \beta_2 UTIL + \beta_3 AT_i + \beta_4 ESTCAP_i + \beta_5 INST_i + \beta_6 CRL_i + \beta_7 INTCAP_i + \beta_8 TCON_i \quad [10]$$

Where, Y_i = performance variables of: RPL and Q; and X_i = ownership structure variables: CON, CON3, HCON and CE.

$$Y_i = \beta_1 X_i + \beta_2 X_i^2 + \beta_3 UTIL + \beta_4 AT_i + \beta_5 ESTCAP_i + \beta_6 INST_i + \beta_7 CRL_i + \beta_8 INTCAP_i + \beta_9 TCON_i \quad [11]$$

The coefficients' expected signs are in accordance with the literature review expressed in sections 2.1 and 2.2. In this stage 16 models will be estimated (MOD1 to MOD16): one for each dependant variable (RPL and Q) and for each ownership structure variable (CON, CON3, HCON and CE) in accordance with equation 10 – in the total of 8 models; and one for each dependant variable (RPL and Q) and for each ownership structure variable (CON, CON3, HCON and CE) in accordance with equation 11 – in the total of 8 models.

Later the determinants of the ownership structure will be analyzed in such way that, at this moment, the variables of the shareholding control concentration will be considered as dependants. Schematically, it derives to equation 12:

$$X_i = \beta_1 UTIL + \beta_2 AT_i + \beta_3 ESTCAP_i + \beta_4 INST_i + \beta_5 TCON_i \quad [12]$$

Where, X_i = are the ownership structure variables CON, CON3, HCON and CE.

It is important to notice that it will be enclosed in the determinant analysis models of the ownership structure, only the variables identified in the literature as its main influent (DEMSETZ and LEHN; PEDERSEN and THOMSEN, 1997; SIQUEIRA, 1998). The coefficients expected signs are in accordance with the literature review expressed in section 2.1 and 2.2. In this stage, 4 models will be estimated (MOD17 to MOD20): one for each dependant variable (CON, CON3, HCON and CE).

For the valuation of all the models, the interval variables (except for the *dummy* variables) will be standardized, as in equation 13, in such a way that:

$$\frac{X_j - \bar{X}}{S_x} \quad [13]$$

Where, X_j = research interval variable j (section 3.2); \bar{X} = average of the interval variable j; and S_x standard deviation of the interval variable j.

The idea behind the standardization of the variables is to have the estimated coefficients (β_j) describing the relative importance of the explanatory variables in a multiple regression model. In other words, “the standardized coefficient adjusts the estimated parameter that represents the inclination by the ratio between the standard deviation of the explanatory variable and of the dependant variable” (PINDYCK and RUBINFELD, 2004, p.111). Thus, a standardized coefficient of any interval variable in equations 10 to 12 of 0.7 means that a change of 1 in the standard deviation of the explanatory variable will lead to a change of 0.7 in the standard deviation of the dependant variable. This procedure makes it possible to compare the importance of the explanatory variables in the determination of the dependant variables, mainly for the models developed in equation 3.13 where the objective is to analyze the main determinants of the ownership structure. With the variables standardization the angular coefficients in equations 10 to 12 are equal to zero.

All the models will be estimated by the method of the Ordinary Least Squares (OLS) in such a way that, the validity of the inferences will be evaluated by its adherence to the presumed normality and heteroscedasticity. As the existence of heteroscedasticity is *a priori* suspected, the models will be estimated with standard errors consistent with the heteroscedasticity according to White (1980).

Results of the Research Descriptive analysis of the data

Ownership Structure of the non-financial companies

Much though in the development of the models it has been taken the position of each variable of the ownership structure and control in the year of 2001, these data had been described with the objective of identifying the average profile of the public non-financial companies based on the sample collected in each year of the study.

In Table 8 it can be observed that the average concentration of votes of the controlling shareholders is high in the non-financial Brazilian companies, presenting a general average of approximately 60%. The three main shareholders (CON3) on average possess approximately 81% of the votes, confirming the findings of Leal *et al.* (2000) and Carvalhal-da-Silva (2004) that affirm that in general the Brazilian public companies are controlled by the three main shareholders. The analysis of the evolution of the

numbers throughout the years, as well as in Okimura (2003), shows a weak increase of the level of concentration of votes of the main shareholder and the three main ones, going from respectively, of 55.36% in 1997 to 62.24% in 2001, and 79.36% in 1997 to 82.61% in 2001.

Table 8. Ownership Structure of the non-financial companies 1997 to 2001

	Year	Variables	
		CON (%)	CON3 (%)
Average	1997	55.36	79.36
	1998	57.63	79.71
	1999	60.71	81.85
	2000	60.90	82.13
	2001	62.24	82.61
General Sample	Average	59.48	81.18
	Median	59.95	84.90
	Standard Deviation	26.23	18.60

Financial performance and value of the non-financial companies

The data relative to the variables of Tobin's Q value and financial performance, measured for the RPL, are summarized in Table 9. As it can be observed, on average the Brazilian non-financial companies have destroyed value or invested in projects that do not maximize the value for the shareholders throughout the analyzed period – at least in the perception of the market. This finding is also shared by Okimura (2003). In the general, the Q variable presented an average of 0.34 for the analyzed period, substantially lower to 1. The financial performance variable comes to prove the value reduction suffered by the

companies in the period analyzed, once the variable RPL presented on average a negative value of 10.8%. It is also noticed, for the variable RPL, the great variability of financial performance among the companies, fact evidenced by the high standard deviation of 62.7%. Another important factor, as it can be noticed not only for the Q variable, but also for the RPL variable, the companies performance improved from 1997 to 2001, showing ascending evolution in the values of the two variables.

Table 9. Financial performance and value of the non-financial companies 1997 to 2001

	Year	Variables	
		Q	RPL
Average	1997	0.29	-17.37
	1998	0.27	-14.07
	1999	0.40	-13.51
	2000	0.36	-3.19
	2001	0.37	-6.26
General Sample	Average	0.34	-10.80
	Median	0.32	2.70
	Standard Deviation	0.36	62.71

Other variables of the non-financial companies

Table 10 presents the other variables considered in the study, except variables UTIL and TCON. These variables had shown constant ratio in the analyzed period, in general approximately 5% of the sample were composed of public utility companies: telecommunications, energy and gas (UTIL=1); and in about 6.5% of the sample the type of control was of foreign capital (TCON=0).

Table 10. Other variables of the non-financial companies 1997-2001

	Year	Variables				
		AT (R\$000)	ESTCAP	CRL (%)	INTCAP	INST
Average	1997	1,438,900	0.45	9.02	1.23	-
	1998	1,393,086	0.44	0.29	2.67	-
	1999	1,540,878	0.40	17.69	4.18	-
	2000	1,776,069	0.40	17.01	7.63	-
	2001	1,982,239	0.40	11.63	7.85	-
General Sample	Average	1,633,347	0.42	11.29	4.82	30.36
	Median	360,396	0.41	10.50	0.88	11.40
	Standard Deviation	5,002,028	0.23	32.68	41.90	47.54

In relation to the data described on Table 10, it becomes necessary to emphasize some evidences: a) the high variability and asymmetry of the size of the companies – coefficient of variation of 306.24% ($5,002,028 \div 1,633,347 \times 100$) and median substantially far from the average for the variable AT; b) capital structure (ESTCAP) relatively constant throughout the years, with an average of 42% of equity in relation to the asset; c) lack of trend in the growth of the net revenue (CRL) throughout the years and high variability – coefficient of 289.45% variation ($32.68 \div 11.29 \times 100$); d) substantial increase of the capital intensity throughout the years with high variability and asymmetry – going from 1.23 in 1997 to 7.85 in 2001 with a coefficient of variation of 869.29% ($41.90 \div 4.82 \times 100$), and substantial

distance from the median in relation to the average, and e) the variable profitability instability (INST) measured by the standard deviation of the equity profitability (RPL), presents an average of 30.36% and standard deviation of 47.54, indicating a significant instability of the variable RPL in the period analyzed.

Analysis of the Models Relation among financial performance and value of the companies with the property structure

All the models for the analysis were estimated by OLS with standard deviation consistent with the heteroscedasticity in accordance with White (1980),

mainly due to the presence of heteroscedasticity in the residues. As the samples in all the models are big enough the Central Limit Theorem is used and it is inferred, through Test *t* and *F*, the individual and joint significance of the estimated coefficients. Table 11 to 14 present the developed models in accordance with equation 10 (linear relation) using each one of the

performance variables alternatively (Q and RPL) as dependant variables and of ownership structure (CON, CON3, HCON and CE) as independent variables. In total 8 models for the equation 10 had been estimated (MOD1 to MOD8).

Table 11. Models 1 and 2 Equations

Model	Variable		Coefficient	Standard Deviation	T-Statistics	p-value
	Dependant	Independent				
MOD1	RPL	CON	-0.0722	0.0475	-1.5189	0.1307
		UTIL	-0.2124	0.1205	-1.7617	0.0800
		AT	0.0690	0.0262	2.6345	0.0092
		ESTCAP	0.2495	0.1287	1.9391	0.0542
		INST	-0.2688	0.3524	-0.7627	0.4467
		CRL	0.2775	0.1275	2.1756	0.0310
		INTCAP	0.0535	0.0592	0.9040	0.3673
		TCON	0.0066	0.0725	0.0917	0.9271
MOD2	Q	CON	0.0832	0.0616	1.3512	0.1786
		UTIL	1.0113	0.3258	3.1036	0.0023
		AT	0.1996	0.0523	3.8196	0.0002
		ESTCAP	-0.3301	0.0702	-4.7057	0.0000
		INST	0.2347	0.0818	2.8680	0.0047
		CRL	-0.0771	0.0938	-0.8215	0.4126
		INTCAP	-0.0190	0.0638	-0.2980	0.7661
		TCON	-0.0585	0.0713	-0.8205	0.4132

Table 12. Models 3 and 4 Equations

Model	Variable		Coefficient	Standard Deviation	T-Statistics	p-value
	Dependant	Independent				
MOD3	RPL	CON3	-0.0342	0.0390	-0.8788	0.3808
		UTIL	-0.2314	0.1211	-1.9114	0.0577
		AT	0.0715	0.0294	2.4321	0.0161
		ESTCAP	0.2512	0.1289	1.9485	0.0531
		INST	-0.2767	0.3536	-0.7826	0.4350
		CRL	0.2764	0.1280	2.1595	0.0323
		INTCAP	0.0518	0.0584	0.8883	0.3757
		TCON	0.0087	0.0720	0.1205	0.9042
MOD4	Q	CON3	0.0720	0.0585	1.2302	0.2205
		UTIL	1.0118	0.3158	3.2040	0.0016
		AT	0.2025	0.0515	3.9333	0.0001
		ESTCAP	-0.3330	0.0719	-4.6325	0.0000
		INST	0.2399	0.0807	2.9733	0.0034
		CRL	-0.0747	0.0931	-0.8027	0.4234
		INTCAP	-0.0193	0.0636	-0.3030	0.7623
		TCON	-0.0600	0.0716	-0.8387	0.4029

In general, models MOD1 to MOD8 shown: a) coefficients jointly significant: in all models the statistics *F* is significant at 1%; b) the coefficient of determination (*R*²) around 0.30: there were no

meaningful differences among the different ownership structure variables in explaining the variables Q and RPL; c) individual coefficients of all ownership structure variables equal to zero at 10% significance

level. Specifically, in relation to the models of the RPL dependant variable it was obtained: a) negative and significant effect of the UTIL variable at a 10% level; b) positive and significant effect of the AT variable at a 5% level; c) positive and significant influence of the ESTCAP variable at a 10% level; and d) positive significance of the variable CRL at a 5% level. In relation to the models of the Q dependant variable, the variables UTIL, AT, ESTCAP and INST presented significance at a 1% level. It is also important to notice the contrary signs of the variables UTIL and ESTCAP in the models of the different

performance variables: in the models where RPL is the dependant variable, UTIL is negative and ESTCAP is positive; in the models where Q is the dependant variable, UTIL is positive and ESTCAP is negative.

Tables 15 to 18 present the models developed in accordance with equation 11 (quadratic relation) using alternatively each one of the performance variables (Q and RPL) as dependant variables and of ownership structure (CON, CON3, HCON and CE) as independent variables. In total 8 models had been all estimated (MOD9 to MOD16).

Table 13. Models 5 and 6 Equations

Model	Variable		Coefficient	Standard Deviation	T-Statistics	p-value
	Dependant	Independent				
MOD5 <i>N</i> = 169 <i>R</i> ² = 0.307 <i>F</i> = 13.61	RPL	HCON	-0.0595	0.0515	-1.1539	0.2502
		UTIL	-0.2188	0.1233	-1.7750	0.0778
		AT	0.0683	0.0279	2.4455	0.0155
		ESTCAP	0.2479	0.1291	1.9208	0.0565
		INST	-0.2718	0.3521	-0.7720	0.4412
		CRL	0.2765	0.1279	2.1622	0.0321
		INTCAP	0.0517	0.0586	0.8829	0.3786
		TCON	0.0074	0.0726	0.1017	0.9192
MOD6 <i>N</i> = 164 <i>R</i> ² = 0.317 <i>F</i> = 10.33	Q	HCON	0.1019	0.0625	1.6289	0.1054
		UTIL	0.9986	0.3288	3.0366	0.0028
		AT	0.2054	0.0535	3.8382	0.0002
		ESTCAP	-0.3271	0.0698	-4.6876	0.0000
		INST	0.2329	0.0823	2.8301	0.0053
		CRL	-0.0762	0.0929	-0.8201	0.4134
		INTCAP	-0.0185	0.0633	-0.2920	0.7707
		TCON	-0.0567	0.0709	-0.7999	0.4250

Table 14. Models 7 and 8 Equations

Model	Variable		Coefficient	Standard Deviation	T-Statistics	p-value
	Dependant	Independent				
MOD7 <i>N</i> = 169 <i>R</i> ² = 0.306 <i>F</i> = 13.73	RPL	CE	0.0513	0.0560	0.9166	0.3607
		UTIL	-0.2342	0.1190	-1.9684	0.0507
		AT	0.0740	0.0268	2.7606	0.0064
		ESTCAP	0.2461	0.1297	1.8978	0.0595
		INST	-0.2738	0.3516	-0.7786	0.4374
		CRL	0.2774	0.1278	2.1698	0.0315
		INTCAP	0.0494	0.0584	0.8466	0.3985
		TCON	0.0087	0.0726	0.1205	0.9042
MOD8 <i>N</i> = 164 <i>R</i> ² = 0.312 <i>F</i> = 10.50	Q	CE	-0.0718	0.0653	-1.0993	0.2733
		UTIL	1.0306	0.3317	3.1072	0.0022
		AT	0.1946	0.0523	3.7200	0.0003
		ESTCAP	-0.3241	0.0696	-4.6530	0.0000
		INST	0.2387	0.0824	2.8981	0.0043
		CRL	-0.0773	0.0935	-0.8269	0.4095
		INTCAP	-0.0144	0.0642	-0.2240	0.8230
		TCON	-0.0599	0.0714	-0.8392	0.4026

In general, models MOD9 to MOD16 shown: a) jointly significant coefficients: in all the models *F* statistics is significant at 1%; b) coefficient of determination (R^2) around 0.30: there were no meaningful differences among the different ownership

structure variables (and the square ownership structure) in explaining Q and RPL variables; c) joint coefficient of all ownership structure and square ownership structure variables statistically equal to zero at 10% significance level.

Table 15. Models 9 and 10 Equations

Model	Variable		Coefficient	Standard Deviation	T-Statistics	p-value
	Dependant	Independent				
MOD9	RPL	CON	-0.0701	0.0497	-1.4117	0.1600
		CON2	0.0235	0.0650	0.3619	0.7179
		UTIL	-0.2138	0.1242	-1.7218	0.0870
		AT	0.0717	0.0298	2.4053	0.0173
		ESTCAP	0.2529	0.1339	1.8886	0.0608
		INST	-0.2677	0.3542	-0.7557	0.4509
		CRL	0.2778	0.1282	2.1665	0.0318
		INTCAP	0.0558	0.0620	0.8993	0.3698
		TCON	-0.0171	0.0891	-0.1921	0.8479
MOD10	Q	CON	0.0909	0.0624	1.4577	0.1469
		CON2	0.0780	0.0629	1.2399	0.2169
		UTIL	1.0045	0.3345	3.0034	0.0031
		AT	0.2082	0.0538	3.8729	0.0002
		ESTCAP	-0.3176	0.0704	-4.5147	0.0000
		INST	0.2383	0.0841	2.8324	0.0052
		CRL	-0.0773	0.0927	-0.8339	0.4056
		INTCAP	-0.0120	0.0618	-0.1950	0.8457
		TCON	-0.1351	0.0999	-1.3519	0.1784

Table 16. Models 11 and 12 Equations

Model	Variable		Coefficient	Standard Deviation	T-Statistics	p-value
	Dependant	Independent				
MOD11	RPL	CON3	-0.0123	0.0708	-0.1731	0.8628
		CON32	0.0192	0.0398	0.4825	0.6301
		UTIL	-0.2351	0.1238	-1.8990	0.0594
		AT	0.0739	0.0321	2.3044	0.0225
		ESTCAP	0.2534	0.1306	1.9406	0.0541
		INST	-0.2764	0.3545	-0.7797	0.4367
		CRL	0.2787	0.1299	2.1459	0.0334
		INTCAP	0.0531	0.0584	0.9091	0.3647
		TCON	-0.0106	0.0869	-0.1221	0.9029
MOD12	Q	CON3	0.1025	0.0913	1.1226	0.2633
		CON32	0.0261	0.0473	0.5504	0.5828
		UTIL	1.0066	0.3140	3.2053	0.0016
		AT	0.2058	0.0530	3.8811	0.0002
		ESTCAP	-0.3304	0.0717	-4.6113	0.0000
		INST	0.2403	0.0814	2.9525	0.0036
		CRL	-0.0717	0.0936	-0.7661	0.4448
		INTCAP	-0.0177	0.0626	-0.2819	0.7784
		TCON	-0.0861	0.0944	-0.9122	0.3631

Specifically, in relation to the models of the Q dependant variable, it were reached the same findings of the equation 10 models: a) the negative and significant effect of the UTIL variable at a 10% level; b) positive and significant effect of the AT variable at a 5% level; c) positive and significant influence of the ESTCAP variable at a 10% level; and d) positive significance of the CRL variable at a 5% level. Also in relation to the Q dependant variable models, the

UTIL, AT, ESTCAP and INST variables had presented significance at a 1% level. The contrary signs of the UTIL and ESTCAP variables in the models of the different performance variable are outstanding: in the models where RPL is the dependant variable, the UTIL is negative and the ESTCAP is positive; in the models where Q is the dependant variable, UTIL is positive and ESTCAP is negative.

Table 17. Models 13 and 14 Equations

Model	Variable		Coefficient	Standard Deviation	T-Statistics	p-value
	Dependant	Independent				
MOD13 <i>N = 169</i> <i>R² = 0.307</i> <i>F = 12.06</i>	RPL	HCON	-0.0577	0.0466	-1.2384	0.2174
		HCON2	-0.0049	0.0694	-0.0702	0.9441
		UTIL	-0.2201	0.1170	-1.8811	0.0618
		AT	0.0682	0.0286	2.3805	0.0185
		ESTCAP	0.2476	0.1323	1.8712	0.0631
		INST	-0.2722	0.3558	-0.7650	0.4454
		CRL	0.2764	0.1293	2.1375	0.0341
		INTCAP	0.0511	0.0627	0.8151	0.4162
		TCON	0.0124	0.0935	0.1330	0.8944
		MOD14 <i>N = 164</i> <i>R² = 0.324</i> <i>F = 9.61</i>	Q	HCON	0.0685	0.0645
HCON2	0.0984			0.0657	1.4984	0.1361
UTIL	1.0217			0.3377	3.0255	0.0029
AT	0.2074			0.0527	3.9353	0.0001
ESTCAP	-0.3180			0.0706	-4.5020	0.0000
INST	0.2399			0.0850	2.8233	0.0054
CRL	-0.0751			0.0912	-0.8236	0.4114
INTCAP	-0.0069			0.0608	-0.1143	0.9092
TCON	-0.1560			0.1004	-1.5527	0.1225

Table 18. Models 15 and 16 Equation

Model	Variable		Coefficient	Standard Deviation	T-Statistics	p-value
	Dependant	Independent				
MOD15 <i>N = 169</i> <i>R² = 0.307</i> <i>F = 13.13</i>	RPL	CE	0.0625	0.0550	1.1365	0.2574
		CE ²	0.0290	0.0700	0.4144	0.6791
		UTIL	-0.2376	0.1234	-1.9258	0.0559
		AT	0.0755	0.0274	2.7522	0.0066
		ESTCAP	0.2474	0.1306	1.8938	0.0601
		INST	-0.2741	0.3521	-0.7785	0.4374
		CRL	0.2770	0.1278	2.1679	0.0316
		INTCAP	0.0524	0.0610	0.8591	0.3916
		TCON	-0.0201	0.0951	-0.2109	0.8332
		MOD16 <i>N = 164</i> <i>R² = 0.316</i> <i>F = 9.27</i>	Q	CE	-0.0432	0.0716
CE ²	0.0783			0.0803	0.9745	0.3313
UTIL	1.0206			0.3418	2.9860	0.0033
AT	0.1988			0.0520	3.8199	0.0002
ESTCAP	-0.3204			0.0711	-4.5052	0.0000
INST	0.2376			0.0847	2.8072	0.0056
CRL	-0.0791			0.0924	-0.8562	0.3932
INTCAP	-0.0065			0.0634	-0.1024	0.9186
TCON	-0.1365			0.1058	-1.2899	0.1990

Determinants of the ownership structure of the non-financial companies

Table 19 presents the models developed in accordance with equation 12, which aims at identifying the determinants of the ownership structure of capital of the non-financial public companies in Brazil: for each ownership structure variable a model was estimated, being a total of 4 models (MOD17 to MOD20).

Analyzing the level of adjustment of the equation 12 models: a) coefficients jointly significant at a 5% level, for the *F* statistics, in models MOD17, MOD18 and MOD19 and joint non significance of the coefficient at a level of 10% in model MOD20; b) coefficients of determination (R^2) low in all the models (around 0.05); c) non significance in all the models for the variables ESTCAP and TCON.

Table 19. Models 17 to 20 Equations

Model	Variable		Coefficient	Standard Deviation	T-Statistics	p-value
	Dependant	Independent				
MOD17 <i>N</i> = 171 R^2 = 0.047 <i>F</i> = 2.97	CON	UTIL	0.5684	0.2756	2.0627	0.0407
		AT	-0.0956	0.0633	-1.5116	0.1325
		ESTCAP	-0.0080	0.0781	-0.1030	0.9181
		INST	0.1658	0.0593	2.7960	0.0058
		TCON	-0.0507	0.0819	-0.6184	0.5371
MOD18 <i>N</i> = 171 R^2 = 0.050 <i>F</i> = 8.43	CON3	UTIL	0.6607	0.1594	4.1461	0.0001
		AT	-0.1534	0.0313	-4.9024	0.0000
		ESTCAP	0.0221	0.0703	0.3148	0.7533
		INST	0.1243	0.0510	2.4379	0.0158
		TCON	-0.0609	0.0840	-0.7247	0.4696
MOD19 <i>N</i> = 171 R^2 = 0.055 <i>F</i> = 3.37	HCON	UTIL	0.5712	0.2666	2.1426	0.0336
		AT	-0.1319	0.0629	-2.0979	0.0374
		ESTCAP	-0.0328	0.0785	-0.4178	0.6766
		INST	0.1564	0.0593	2.6364	0.0092
		TCON	-0.0506	0.0818	-0.6184	0.5371
MOD20 <i>N</i> = 171 R^2 = 0.040 <i>F</i> = 1.77	CE	UTIL	-0.3727	0.3679	-1.0130	0.3125
		AT	0.0475	0.0894	0.5315	0.5958
		ESTCAP	0.0744	0.0815	0.9136	0.3623
		INST	-0.1447	0.0709	-2.0422	0.0427
		TCON	0.0346	0.0809	0.4281	0.6692

Final Aspects

In countries with high stock concentration and with little developed stock market as in Latin America and special in Brazil, one of the corporate governance main issues is the conflict of agency existing between minority and main shareholders. Several empirical studies state that a higher concentration of the rights to vote by the controlling shareholders would be associated with a higher expropriation of the minority stockholders and thus lower value and performance of the companies (entrenchment effect).

On the other hand, the stock concentration can be connected to the possibility of the owners to monitor the management with a probable reduction of the conflicts and costs of agency. Existing empirical evidences had shown that the presence of controlling shareholders increases the relation benefits/costs of the monitoring, implying optimized solutions for the agency conflicts issue and increasing the companies' value and performance (alignment effect).

Moreover, the literature also worries, beyond searching evidences for the consequences of the stock concentration on the companies' value and

performance, to know the causes of the stock concentration. Several researches since the eighties, considering European, North American and Asian companies, have been testing the hypotheses that forces such as the level of regulation of the sectors, the size of the firm, the instability of the markets, the capital structure of the company and the type of controlling shareholder exert a relevant role on the level of ownership concentration.

This research main objective was to investigate the existence of influence of the ownership concentration on the financial performance and value of the companies (consequences), and which are the determinants of the ownership concentration in Brazil (causes), amongst the five cited variables.

In the empirical investigation, models had been estimated based on the Ordinary Least Squares method (OLS) with standard errors consistent with the heterocedasticity in accordance with White (1980), built based on the theory. The analysis sample was obtained from the population of 459 companies listed in the São Paulo Stock Exchange (BOVESPA) in 2001 with data available in the Economática®'s data base. For the development of the study, it were

considered all the public non-financial companies negotiated in the São Paulo Stock Exchange, with available data for, at least three of the five studied years (1997 to 2001), resulting in a total of 176 companies.

By the methodology adopted, it was not possible to prove the relation between the ownership structure variable and the companies' financial performance and value. In relation to the causes of the ownership structure of the Brazilian public non-financial companies, the results show evidences that the ownership structure can be explained by the size of the firm, by the market instability and regulation. The market regulation variable revealed itself as the main determinant of the ownership structure.

The present research was oriented in the direction of contributing for the theoretical and empirical studies on the causes and consequences of the ownership structure in Brazil. It did not have the intention to deplete the subject discussion, but mainly to stimulate new research subjects and adoption of new methodologies, that can confirm the results obtained or extend the analyzes' horizon. The subject, in spite of its relative importance and increasing discussion in the academy, deserve to be highlighted, due to the need of improving analyzes and conclusions on the best ownership structure and control for the Brazilian companies. It is suggested, as a way of improving the research subjects, the use of alternative statistical methods, for example Least Squares in 2 Stages or 3 Stages and panel data analysis, with a longer and more distinct time horizon than it was adopted, beyond the inclusion of variables different from the ones selected in this research.

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DETERMINANTS OF PERFORMANCE OF CLOSELY – HELD (FAMILY) FIRMS AFTER GOING PUBLIC: THE ROLE OF THE OWNERSHIP STRUCTURE, ECONOMY, CHANGES IN TOP MANAGEMENT, PARTIAL SALE, EQUITY CONCENTRATION AFTER THE IPO AND SHAREHOLDERS IN MANAGEMENT

J. Vaz Ferreira*

Abstract

When a closely-held (family) company goes public, there are very specific and particular determinants that have crucial influences on the post-going public operational, social and financial performance of those firms. We investigate why firms decline significantly their profitability, efficiency, employment and activity levels, and show an increase on sales and capital investment when there is a transition from private to public ownership. We conclude that this decrease in performance is significantly higher, when one or more than one of the following facts happen after firms going public: first, when there are not shareholders in management, what implies increased agency costs; secondly, when the level of equity concentration after going public is low; in third place, when the level of equity retention by the founding shareholder is low; fourth, when the economy health during the timing of the sale is not in good shape; and lastly, when the old CEO is changed.

Keywords: Initial public offerings; Going public; Separation of ownership and control; Economic, social, financial and dividend performance of closely held companies

Please address correspondence to: J. VAZ FERREIRA, Coimbra University, School of Economics and Management, Av. Dias da Silva, nº 165, 3004-512 Coimbra, Portugal; Tel.: 351 239 790 500, e-mail: jvazfer@fe.uc.pt.

1. Introduction

The decision to go public is, probably, one of the most important steps on a firm's life. There is an idea that, going public, through an initial public offering (IPO) or through a direct sale (DS) is a simple normal stage in the growth of a company. This idea is not correct, since there are old and large companies that stay closely (family) held companies forever. According to Anderson and Reeb [2003], family firms are those in which the founder or a member of his family is director, or blockholder. According to Pagano *et al.* [1998] companies go public for the following reasons: in first place, the market-to-book ratio at which firms in the same industry trade, can induce additional investment, mainly in sectors with great growth opportunities; in second place, the size of the company, since greater companies are more likely to go public; in third place, most of the times, companies go public after major investments and abnormal growth; therefore, the decision to go public can be explained as an attempt to rebalance their balance sheet after large investments and growth. If we consider the post going public process, Pagano *et al.* [1998] concluded for a reduction in the financial leverage and a reduction on the cost of bank credit of

firms after going public. By last, they found little evidence on portfolio diversification in the decision to go public.

While our study follows the spirit of a few early studies, we make the following empirical contributions. First, we perform the first panel data estimation of the effects of the going public process using firm-level data, rather than just country-level information. Employing specific individual observations for the all sample, allows us to examine the company-specific sources of any performance changes documented after becoming public. In particular, we can study how shareholders in management, ownership, the equity concentration after the IPO or the CEO change, have or have not impact in the profitability, efficiency, activity levels, employment, real sales, short term equilibrium or the capital structure of the new public firms. Second, our investigation is the first work developed in Portugal for a sample of closely (family) firms to empirically examine the causes (determinants) of a certain family firm behaviour after the going public process, concluding, among others things that, per se, going public does not mean operational, social and financial performance improvements. Third, becoming public is a complex and extended process. We distinguish

between markets for dispersed shares, from markets for controlling blocks that can happen with direct sales (DS). Fourth, our database includes information about companies going public from 1986 to 2004 (25 (twenty five) companies). That is, our sample is dispersed for a large period of time and, in addition, our database includes companies in multi-sectors, multi-industries and multi-samples, to better understand the determinants of certain performance behaviour of those firms after the going public process. Lastly, we feel that a multi-industry sample of closely-held firms provides a general perspective of the process of opening the capital to investors and it gives us interesting opportunities to identify the sources, the determinants of the operational and financial performance of the companies after going public. Using panel data analysis, we research the economic, ownership structure and other causes of performance changes in closely-held firms after going public. Such insights regarding the determinants of post-IPO performance behaviour should provide valuable guidance to investors, managers and financial economists.

This paper is organized as follows. Section 2 provides the theoretical and empirical research on the process of going public for the closely-held companies. Section 3 appoints some potential determinants of post-going decision on the operational, social and financial performance of the new open firms. Section 4 describes the methodology, empirical proxies. Data and sample collection we employ are described in Section 5. Section 6 presents the empirical results. Section 7 presents the summary and conclusions.

2. Literature review

Does ownership structure matter to firm performance? Why certain companies have large block holders and other do not? Should the power of large shareholders be limited to avoid expropriation or encouraged to curb managerial discretion? These and other questions have been investigated in corporate finance literature, trying to understand the relationship between ownership structure and firm performance.

When a company decides to go public, their shareholders believe that they obtain several benefits, in spite of some costs, that will result from the decision to raise an IPO or sale directly to the public in general; as a matter of fact, the decision to go public will have very important consequences on the short and long term company future, since, from that point of view, many aspects related with the company life, will change due to that so crucial decision on the firm's future life. Pagano *et al.* [1998] investigated the determinants of the decision to go public and he concluded that they can be inferred both from the ex ante characteristics of the companies that go public and from the ex post consequences of that decision on a company's investment and financial policy. They pointed out a few determinants and some effects of

the decision to go public as follows (before IPO): in first place, they found that the main factor affecting the probability of an IPO is the market-to-book ratio at which companies in the same industry trade. The second most important determinant is the size of the company: larger and more profitable companies are more likely to go public. Among the post-IPO effects that they found a reduction in profitability, what is consistent with other authors, such as, Jain and Kini [1994] and Mikkelsen *et al.* [1996]. They also found that independent companies experience a reduction in the cost of the bank credit after the IPO. On the contrary, Duque and Febra [2002, 2003] did not find a significant reduction on the bank credit cost. They found little evidence that portfolio diversification is relevant to go public.

Pagano *et al.* [1998] found that the change in the ownership structure and in the controlling shareholder is considered a very important determinant to go public. As a matter of fact, if the IPO is followed by substantial divestment by the controlling shareholders, the motivation of the IPO is to allow those shareholders to diversify their portfolio or increase consumption, rather than to look for new sources of finance for company investment. Pagano *et al.* [1998] concluded that IPOs are followed by a very high turnover in control and this happens even though the controlling group always retains a large controlling block after the IPO. This is consistent with Zingales [1995] conclusion that IPOs are undertaken to maximize the proceeds from the sale of the company. This is a crucial area that can give us some insights into the motives to go public if the change in the structure of ownership and control of the company turns to be a significant reason. For instance, if the IPO is followed by considerable divestment by the old shareholders, the most likely reason for the IPO is to allow them to diversify their investments or increase consumption. According to Duque and Febra [2002, 2003], companies go public through an Initial Public Offering (IPO) to rebalance their capital structure, increase their short run profitability and to finance their future investments. In addition, they concluded that the increase of the company leverage in a certain moment of time does not mean that the firm will decide to go public, through an IPO or other method. Their explanation is that a company with high leverage, that is, with no financial equilibrium, is a negative factor and, as a consequence, these are not good conditions to attract investors through an IPO and a good financial health is a necessary condition for any company to go public. The presence of foreign allocation of control may affect the degree of post going public performance. Anderson *et al.* [1997] find that profitability as measured either by return on equity or revenue per employee is significantly higher for the firms with foreign allocation of control.

A key decision to families is the choice of the method of sale that may be influenced by the following factors: (1) the history of the asset's ownership, (2) the competitive position of the family

company (3) the capital market conditions (4) the sophistication of potential investors. One of the most important methods of going public is through the sale of family property, under which the families trade their ownership position for a cash payment. There are two relevant forms. The first form is direct sales (DS) (or asset sales). The second form is through an initial public offering (IPO). Going public, it may also expose the firm to the discipline of product market competition. Having to compete with other firms for customers and market share may provide the pressure required to stimulate greater efficiency and profitability. The pressure of national and international product market competition may force the firm to operate more efficiently. Vickers and Yarrow [1991] defend that the introduction of competition is the driving force behind post-IPO performance improvements.

3. Potential causes (determinants) of post-going public decision on the operational, social and financial performance of the new public companies

There are many divergences about the causes, the determinants that origin a certain type of performance. In fact, Shleifer and Vishny [1997] concluded that founding-family ownership and control is sometimes understood as a less profitable ownership structure than dispersed ownership and controlling shareholders seek to extract private benefits from the company. On the contrary, DeGeorge and Zeckhauser [1993] and Mikkelsen *et al.* [1997] found a reduction in profitability and efficiency after closely held firms go public. The literature about the determinants of a certain type of performance, after firms going public are not extensive, since only a few authors have developed some investigation on this area. For example, Vickers and Yarrow [1991] defend that the market competition, is the driving force behind post-IPO performance improvements. Therefore, there are different perspectives and findings, not only about the operational, social and financial performance of firms after going public, but also, several visions about the causes that justify a certain type of performance. Our panel data analysis has the aim of testing a certain number of possible determinants and their impact on the performance of firms after the going public process. According to Table 2, we will test the determinants that are shown in the next sections.

Pagano *et al.* [1998] found a higher *investment* need in sectors with high growth opportunities and correspondingly high market-to-book ratio or the entrepreneurs' attempt to time the market. As far as the total investment after going public is concerned, we test the operational, social and financial consequences from companies that developed expansion and modernization projects after going public and we compare the results to those that did not invest significantly after the going public process.

Debt may be related to agency costs in certain firms. If higher debt is used as a bonding device and the fixed committed debt repayments constrain management access to cash [Grossman and Hart, 1986; Jensen, 1986], we may find that the debt level actually relates negatively to agency costs. Since debt ratios vary by industry, debt may be a proxy for industry membership. According to Pagano *et al.* [1998] and Duque and Febra [2002] companies do not go public to finance subsequent investment and growth, but to rebalance their accounts after a period of high investment and growth. Mikkelsen *et al.* [1997] also found that, in the United States, older firms are more likely to use funds raised to pay down debt than to finance growth. To Pagano *et al.* [1998], the going public process enables companies to borrow more cheaply. For those authors, around the IPO date, the interest rate on their short term credit falls and the number of banks willing to lend cheaper to them rises. As far as the total debt after going public is concerned, we test the operational, social and financial consequences from a lower leverage.

A nation's *economic environment* may also affect the magnitude of the change in the firm's operational and financial performance following going public. Kikeri *et al.* [1992] suggest that a country with a sophisticated economy and higher income is more likely to have a market-friendly policy framework. Such factors should increase the chances of successful privatization. To determine the effect of growth in the economy during the pre and post going public period, we use the real GDP growth in the economy (percentage growth in real GDP for three years post-going public over the three year pre-privatization period), as the proxy for the growth in the economy. We expect that going public in high growth economy periods will generate the greatest operational, social and financial performance improvements.

The presence or not of *shareholders in management* has a great influence on the following agency costs: the direct agency cost, which is the difference in dollar expenses between a company with a specific ownership and management structure and the no-agency-cost base case firm. Another type of agency cost can be a proxy for the loss in revenues due to no-efficient asset management, which can be the result of weak capital investment decisions.

According to Jensen and Mecking [1976] and Ang *et al.* [2000], agency costs increase with a reduction in managerial ownership. Considering a firm where a single owner controls 100 percent of the stock but hires an outsider to manage the business. Jensen [1993] 'convergence of interest' hypothesis suggests that managerial shareholdings help align the interest of shareholders and managers, and as the proportion of managerial equity ownership increases, so does corporate performance.

Selling the required number of shares to a *few large investors* or even only one has the advantage of minimizing the information production cost. According to Morck *et al.* [1988] companies with a

large number of dispersed shareholders have little incentive to monitor managers and prevent them from putting their own personal interest above that of the company's shareholders. Equity concentration in blockholders generally conducts to a better operational and financial performance after going public. Holderness and Sheeham [1985] and Barclay and Holderness [1991] show empirical evidence that stock performance gain following block share purchases. Allen and Phillips [2000] also concluded for improved operational and financial performance following block concentration purchases. Allen and Phillips [2000] give additional evidence that activist block concentration purchases are followed by corporate restructuring, abnormal share price appreciation and industry adjusted operational profitability gains. In spite of some findings, some empirical evidence on the impact of shareholders with significant equity holdings on corporate performance remains ambiguous. Some authors, using different samples of firms and different empirical strategies, get different results difficult to compare and sometimes much contradictory.

It is recognized by some authors that the problem in disentangling this relationship is largely due to the pervasive endogeneity of ownership which has to be taken into account in order to get unbiased findings. In addition, the existing empirical evidence suggests that the relationship between ownership and performance may depend on the type of the firm and on the period of observation in the life of the company. As far as we get equity concentration or not in a few shareholders are concerned, we test the operational, social and financial consequences from this concentration after the IPO. To know the consequences of a *total or a partial* initial public offering on the operational, social and financial performance of firms after going public is a pertinent question that we want to investigate in this work. As a matter of fact, if we talk about a partial IPO (less than fifty percent), the founding owner choose the managers. In such a case, the main conflict of interest is between the founding shareholder and the minority shareholders.. A large owner will want to monitor his conduct more closely than a large group of small investors. As far as the founding owner chooses or not a partial or a total IPO are concerned, we test the operational, social and financial consequences for partial versus total initial public offering.

Before or immediately after going public, turnover among members of the Board of Directors and the *change of CEO* is very frequent, most of times, due to political reasons; therefore, there is no stability inside the Board. Anderson and Reeb [2003] found that performance appears to be better in the presence of founder CEOs or hired CEOs, with no changes on the CEO. They concluded that family firms, with either a family member or a hired CEO, without changes at this level, exhibit superior firm performance relative to no family firms with CEO changes. As far as the CEO is concerned, we test

whether or not a CEO change has a positive or a negative impact on post-going performance.

According to Allen and Faulhaber [1989], Grinblatt and Hwang [1989] and Welch [1989] have suggested that issuers use *underpricing* as a mechanism to signal their quality to the market. In addition, these models posit that high-quality firms underprice their stock at the IPO and, thereafter, they conduct a seasoned offering when market prices are established and there has been an opportunity for information revelation. For those authors, underpricing may be understandable as a signal of future higher operational performance. On the contrary, Jain and Kini [1994] found no relation among IPOs as far as underpricing is concerned.

4. Methodology, empirical proxies and testable predictions

This section is devoted to the used methodology, that is, the panel data analysis, and the empirical proxies and testable predictions.

4.1. The panel data analysis

Panel data estimation has many benefits in what concerns the capture of the variations over time, the pre and post going public periods, of the economic indicators of the firms. It is possible to control differences in individual's specificities and temporal chances over time in every individual; this study will focus in this last one. This estimation has more information and more efficient estimators than cross-section estimation, so the results will be more robust.

The general specification of a panel data regression is as follows, where the individual effects are reflected in the vector z'_i :

$$y_{it} = x'_{it} \beta + z'_i + \varepsilon_{it} \quad (1)$$

As is usual in panel data analysis, as in Baltagi [1995], this study will estimate both a fixed effect and a random effect model for each performance indicator. The fixed effect specification assumes that company-specific effects are fixed parameters to be estimated, whereas the random effect model assumes that companies constitute a random sample. In a fixed effects model, it is assumed that differences between individuals will be obtained by the constant term, so that, for each individual, the model is as follows, where 1 is a vector of 1's:

$$y_i = X_i + 1\alpha_i + \varepsilon_i \quad (2)$$

For all individuals, we have the following equation, where D is a matrix of 1's and zeros and ε is the error term that is uncorrelated with the independent variable:

$$y = X\beta + D\alpha + \varepsilon \quad (3)$$

In a random effects model, the constant term is unique for every individual and there exists a random specific effect for each individual, so, this effect will be obtained, but it will not be seen. The equation for estimation of this model is, as follows, where U_i is the

specific random effect and ε_{it} is the common error term. In order to test which model is more appropriate, it will be used the Hausman test that, following the estimation of both models, will inference which model has the most efficient estimator:

$$y_{it} = x'_{it} \beta + \alpha + u_i + \varepsilon_{it} \quad (4)$$

In other words, the Hausman test measures whether the random effects are correlated with the explanatory variables, which in turn implies that coefficients estimated by the fixed-effect estimator and those estimated by the random effect estimator do not statistically differ.

4.2. Empirical proxies

The principal aim of our panel data analysis is to test the determinants of a certain operational, social and financial performance behaviour of closely (family) held companies after becoming public. We will test the impact on performance of expansion and modernization investment projects, the impact of the amount of debt on post-IPO performance, the consequences of changes in the development progress of the economy health on the operational behaviour of those closely-held firms, we test whether or not shareholders in management is a significant determinant of future performance for those firms. In addition, we test the consequences of high concentration of the equity sold to a few number of shareholders or, on the contrary, to a high number of minority shareholders. We test the differences in performance between partial and total IPOs and, lastly, we test if it is better for those family firms to keep their CEOs after the IPO or, on the contrary, it is better to change them. In order to pursue this objective, we define the following independent variables to control for company specific effects: investment, assets, total debt and the growth in the economy. To test the effects on the closely-held stock of the going public process, we also construct the following indicators: the dummy "Shareholders in Management" that takes the value 1 if the old closely-held company has shareholders in management after going public. The dummy "Concentration after the IPO" with the value 1 if the old closely-held company sold its equity to one or to a few shareholders with more than 50 percent of the capital sold. The dummy "Partial IPO" with the value 1 if we deal with a partial IPO. Finally, if the dummy "CEO" has the value 1, the firm going public does not change its CEO after the IPO. We expect that performance improvements for those firms after going public will be much more pronounced if they develop investment projects, if total debt declines, in high growth economy periods, when there are shareholders in management, when the firm becomes with its equity concentrated in one or a few shareholders after the IPO, when the founding shareholder decides for a partial IPO and when there is no change on CEO.

5. Data and sample collection

We limit our analysis to those closely-held companies that fully or partially open their capital to outside investors through an Initial Public Offering or Direct Sale. We select the initial public offerings or direct sales with information from 1989 to 2004 and have, at least, three annual observations of the annual reports in the years N-5 to N-1 and in the period N+1 to 2004, where the year of going public is defined as year N. In all cases, we required directly from the firms: (1) the offering prospectus for their initial offer, which systematically presents several years of pre going public financial data, as well as details about the offering itself, and (2) the annual reports from the post going public periods. Approximately 80% of the companies we approached, fully or partially, complied with the requests. In multiple cases, we supplemented financial statements sent with secondary sources, namely, financial institutions, Bank of Portugal and Euronext Lisbon databases. We also used personnel contacts with managers of some of those firms. In case of doubts about some aspects of the firms, we also made several phone calls. We did not include any company by relying on secondary sources exclusively. Our data includes 25 closely-held firms that went public with operational, social and financial information from 1989 to 2004. Therefore, our data span a larger time period than any other initial public offering study developed in Portugal. Table 1 provides the following descriptive information on these companies: the name of the company, type of industry, the going public date and the percentage of capital that was sold at the date of the sale. The sample is well diversified, exhibiting a wide temporal dispersion.

6. Empirical results

The panel regressions were done, on one hand, with time effects and, on the other hand, with fixed or random effects. We conclude that the model of random effects is more suitable, so it can be said that firms have a random specific effect, which can be derived of the specificity of their prior going public life activity combined with the specificity of their sector; nevertheless, most of the closely-held firms that went public, show common signs on their direction for certain performance indicators.

In this panel data regression model, the dependent variables are: Profitability I (Operating Income), Profitability II (Return on Sales), Operational Efficiency (Sales Efficiency), Capital Investment (Capital Investment), Real Output (Real Sales), Employment (Employment), Dividend Policy (Dividend to Sales), Activity Levels (Sales to Total Assets), Short Term Equilibrium (Cash and Banks to Short Term Debt) and Capital Structure (Total Debt to Total Assets).

Table 1. Sample of firms going public from 1989 to 2004

Company	Industry	IPO Date	Company	Industry	IPO Date
Água do Luso	Water	2000	Lisgráfica	Graphic Industry	1998
Amieiros Verdes	Textile	1990	Mota & Companhia	Construction	1997
Auto - Industrial	Automobile retail	1997	Orey Antunes	Transportation	1992
Banco Comercial dos Açores	Banking	1996	Papelaria Fernandes	Commerce	1991
Caima	Cellulose and paper	1998	Pararede	Telecommunication and information systems	1999
Cofina	Media and cellulose	1998	Sacor Marítima	Transportation	1989
Compta	Telecommunication and information systems	1995	Salvador Caetano	Automobile Retail	1992
Dom Pedro	Tourism	1996	Soares da Costa	Construction	1991
Engil	Construction	1989	Sonae Imobiliária	Immovable property	1997
Est. Jerónimo Martins	Retailing	1989	Soporcel	Cellulose and paper	1999
Estoril Sol	Tourism	1991	Teixeira Duarte	Construction	1997
F. Ramada	Cellulose and paper	1993	Telecel	Telecommunication	1996
Finibanco	Banking	1998			

Table 2. Definitions of explanatory variables

Variable	Proxy for	Empirical Definition
Investment	Firms' Investment	Firms' Investment after going public.
Total Assets	Efficiency	Ratio of Total Sales to Total Assets.
Total Debt	Capital Structure	Ratio of Total Debt to Total Assets.
Real GDP Growth	Growth in the Economy	Percentage growth in Real GDP for three year post-going public period over the three year pre-going public period.
Shareholders in Management	Corporate Governance	Indicator variable with value = 1 if firm has shareholders in management after going public, 0 otherwise; There are shareholders in management when, at least one shareholder belongs to the Board of Directors.
Equity concentration after going public	Ownership Concentration	Indicator variable with value = 1 if, after going public, shares are concentrated in the same owners, 0 otherwise. There is equity concentration when the majority of equity becomes concentrated in one or a few shareholders.
Partial IPO	Ownership Structure	Indicator variable with value = 1 if it is a partial IPO, 0 otherwise. A partial IPO happens when the founding owner keeps more than 50% of the total capital.
CEO	Top Management	Indicator variable with value = 1 if the firm going public does not change the CEO, 0 otherwise.

Trying to investigate the determinants of the post-going public operational, social and financial performance, we employ the following independent variables: investment and total assets, total debt, real GDP growth, shareholders in management, equity concentration after going public, partial IPO and changes in the top management (CEO). Table 2 present all the independent variables.

6.1. The main determinants and its effects in the operational, social and financial performance of privatized firms

The number of shares sold by the founding owner is a crucial determinant to explain changes on the operational and financial behaviour of the new public firms. A *partial IPO* with large amounts of stock retention by the family owners proves to be a better solution in terms of operational and financial performance than a total IPO, where the majority of

stock is sold to public investors. In a partial IPO (equity sale less than fifty percent), we document significant improvements in profitability, efficiency and financial equilibrium, what did not happen with total IPO, where the founding owner had transferred the control of the firm to new owners. Jain and Kini [1994] and Berle and Means [1932] suggested that a ownership concentration structure should have a positive effect on firm performance and its value because it alleviates the conflicts of interest between owners and managers.

The existence of *management ownership* is one of the most important determinants of firms' performance after going public. We found performance improvements in profitability, efficiency, real sales, capital investment and activity levels, what did not happen with firms with no shareholders in management. Shareholders in management are more likely to show initiative if they have some latitude to make effort and undertake innovative actions. In

Aghion and Tirole [1997] concentrated ownership provides incentives to monitor, but also reduces the manager's initiative or incentive to acquire information.

Recognizing the importance of managerial initiative is at the heart of the theory of Burkart *et al.* [1997]. They argue that increased monitoring by shareholders may be costly because it may depress initiative displayed by managers: managers are less likely to be active if they know that shareholders are likely to interfere. So, too much monitoring may negatively affect managerial initiative and profitable investment opportunities will be lost. Burkart *et al.* [1997] view firm ownership structure as an instrument to solve the trade-off between control and initiative. Through more dispersed ownership structure shareholders commit themselves to weaker intervention which makes managers confident enough that they will not be dispossessed of the benefits of their initiative.

There is a potential for increased agency costs when a firm makes the transition from private to public ownership. The reduction of management ownership that occurs when a firm goes public, normally, leads to agency problems, according to Jensen and Meckling [1976]. Agency theory says that family management has a positive effect on the value of firms. According to Burkart *et al.* [2002] this effect may be offset by the costs of family management if hired professionals are better managers than family founders of their heirs. Consistent with the view that family management mitigates the classic agency problems, Morck *et al.* [1988] found that founder-CEO firms trade at a premium relative to other firms. In spite of the transaction, the presence of some shareholders in management, not only attenuates those agency conflicts, but also, this mixed management structure gets better performance results than management structures without shareholders. Our findings are much closed to those of Singh and Davidson III [2003] who found that higher managerial ownership significantly and positively influences the corporate asset utilization efficiency and it acted as a significant deterrent to excessive discretionary expenses.

Our study appoints to a very important determinant of performance behaviour after the IPO: *the maintenance of the CEO after going public*. If this happens, the results are substantially better, probably because the hypothesis of a new hired CEO has several implications on performance. Firms with the same CEO after going public improved significantly their profitability, efficiency, output, activity levels and capital structure, what did not happen with companies that changed their CEOs.

In fact, family firms, with either a family member or a hired CEO, without changes at this level, exhibit superior firm performance relative to no family firms with CEO changes. The new CEO takes time to get all

the information to run the new public company with the best conditions: knowledge of the business, the sector, the people, the systems, etc. Our conclusions on performance of firm that change or do not change their CEOs after going public are similar to those presented by Anderson and Reeb [2003].

The real output empirical tests provide evidence that the timing of the offer and the amount of *national wealth (GDP)* at that time is a relevant determinant. If the IPO happens when the economy is growing, that is, when the GDP growth rate is high, we found significant performance improvements in output, capital investments, and payout ratio and capital structure, what did not happen in years with low economic growth. The timing and the state of the economy, has a very significant positive relation with post-IPO operational, social and financial performance of the new public firms, leading, in particular, to a real output increase. During the period under analysis, it was demonstrated that economic health conducted to better results for the new public firms.

We found that *equity concentration* is a very relevant determinant of firms after going public. Firms with a more concentrated equity structure perform better than firms with a more dispersed structure. In fact, our findings show that more concentrated structures after the IPO, mean performance improvements, higher profitability and efficiency, improved activity levels and capital structure, what did not happen with dispersed equity structures after going public. Companies with a large number of dispersed shareholders have little incentive to monitor managers and prevent them from putting their own personal interest above that of the company's shareholders. Large shareholders alleviate the agency problem arising from the separation between ownership and control, getting better performance results.

6.2. The determinant's results in performance of the newly privatized firms

The determinants results are developed as follows: profitability I, profitability II, operational efficiency, capital investment, real output, employment, dividend policy, activity levels, short term equilibrium, and capital structure.

In order to measure *profitability*, we used two different indicators: the operational income in absolute terms (OI), and the return on sales indicator (ROS). The results for operating income and ROS are presented in Table 3a. When we analyse the panel regression results of the operating income and the return on sales indicator, we conclude that the observable results are, in a similar way, very similar, no matter the model used on the panel regression.

Some literature, such as, Jain and Kini [1994] concluded that, in general, profitability declines after closely-held firms go public.

TABLE 3a. Results of Panel Data Estimations:
Profitability I, Profitability II, Operational efficiency, and Capital Investment

This table reports the estimates of panel data estimations for operating income of the 25 closely-held firms that went public for the pre and post - IPO period (-3 years; +3 years). The independent variables are explained in Table 2. Each coefficient T-statistics is in brackets and *, denotes significance at 5 percent level.

Independent Variables	Operating Income		Return on Sales		Sales Efficiency		Capital Investment	
	Fixed Effects	Random Effects	Fixed Effects	Random Effects	Fixed Effects	Random Effects	Fixed Effects	Random Effects
CONSTANT	0.021 (0.022)	0.010 (0.012)	0.034 (0.012)	0.054 (0.042)	0.002 (0.021)	0.003 (0.092)	0.012 (0.002)	0.011 (1.478)
INVEST	2.112* (2.783)	3.343* (2.949)	2.688* (2.897)	3.677* (4.202)	2.278* (3.221)	3.987* (4.323)	7.989* (3.767)	9.455* (4.787)
ASSETS	0.148 (0.176)	0.123 (1.133)	0.122 (0.434)	2.443 (1.332)	1.134 (1.456)	2.109 (1.872)	5.949* (3.293)	7.404* (5.323)
TOTAL DEBT	1.190 (1.232)	1.353 (1.365)	1.354 (1.422)	1.403 (1.544)	1.332 (1.112)	1.343 (1.232)	1.603 (1.430)	1.205* (3.023)
GDP	2.665* (2.569)	2.756* (2.966)	2.656* (2.836)	2.304* (2.833)	2.345 (1.554)	2.437 (1.443)	9.040* (6.356)	11.309* (7.388)
SHAREHOLDERS IN MANAGEMENT	1.129* (2.786)	1.148* (2.103)	1.323* (2.774)	2.332* (3.332)	3.787* (4.677)	4.754* (5.787)	3.738* (3.305)	4.767* (4.060)
CONCENTRATION AFTER THE IPO	1.625* (2.344)	1.254* (2.772)	1.333* (2.940)	2.477* (3.254)	2.506* (2.664)	3.452* (3.776)	2.044 (2.032)	2.775* (2.207)
PARTIAL IPO	1.877* (2.232)	1.467* (3.162)	1.767* (2.274)	2.502* (2.868)	1.343* (2.454)	2.202* (3.320)	1.201 (1.211)	1.244 (1.343)
CEO	2.986* (2.254)	3.453* (2.728)	1.232* (2.284)	3.121* (3.332)	2.323* (2.848)	3.332* (3.101)	1.343 (1.301)	1.405 (1.477)
Nobs	92	92	92	92	92	92	92	92
Tests								
F	5.09	6.12	2.11	4.22	1.76	3.44	2.33	4.23
Hausman	1.22	1.34	1.23	1.55	1.32	1.56	1.23	1.44

* rejection of H0 at five percent level of significance

However, our results show that, in certain specific situations, Jain and Kini [1994] findings are not confirmed, that is, profitability presents positive relations in certain situations: for example, one potential explanation for the more or less decline in the post-issue operational and financial performance of IPO firms, are the increased agency costs. There is some work about the relationship between managerial ownership and firm performance. The results are mixed in Hermalin and Weisbach [1991], Demsetz and Lehn [1985], and others. The empirical ambiguity is often referred as evidence of a complex role of insider ownership: while it aligns the interests of managers and shareholders and thus enhances performance, it also negatively affects performance. Because of a reduction on agency costs or other factors, when there are shareholders in management, we observe that profitability is not reduced when firms go public. The same results may happen when the economy is in a good shape, or with a partial IPO or when the closely-held firm CEO doesn't change. All these and other results can be observed in Table 3a.

With the panel data methodology, we employ sales per employee (SALEFF) in thousands of euros, to test for changes in *efficiency* after firms going public, and we control for different levels of the economic development. The results of these estimations are presented in Table 3a. To understand ownership structure is very relevant, since it has a direct influence in the operating efficiency of the market and specifically, in family firms that go public.

A large portion of literature looking for causes of a certain behaviour of firms after going public, has been concerned with explaining the problem of ownership control and management, trying to find out the best way to control firm managers.

Efficiency is related with the level of equity concentration after the firm goes public. When the owners of a company do not exercise control, there is a separation between ownership and control. When this happens, this is a potential agency problem between owners and minority shareholders. The former will not necessarily pursue the objective of the later, which is to maximize the return of their investment. Therefore, mechanisms are needed to be sure that hired managers defend the company investors. Efficiency is directly linked to the possibility of modernization of the firm after going public through investment projects. Besides the determinants developed before (shareholders in management and equity concentration after firms go public), if the old CEO stays on his job is determinant to efficiency after the IPO. Our findings are similar to those as defended by Morck *et al.* [1988].

The results presented in Table 3a for *capital investment* show a significant positive relation with economic growth. When the economy is growing, there are much more investment opportunities and, therefore, it is reasonable to find a positive relationship between both variables. Additionally, the capital investment after the IPO is directly linked with the presence of shareholders in management, since that the presence or not of shareholders in

management has a great influence on agency costs. If agency costs are lower, that means management shareholders are more motivated to invest, since a great part of the firm's efforts before absorbed by those type of costs, are under this scenario, more concentrated on the firm's modernization and on

expansion investment increasing, thus, the capital investment. Lastly, when the economy is in a good shape and it is growing everyday, firms will tend to invest more after going public. This can be done for expansion and for modernization reasons.

TABLE 3b. Results of Panel Data Estimations: Real sales, Employment, and Dividend policy

This table reports the estimates of panel data estimations for operating income of the 25 closely-held firms that went public for the pre and post - IPO period (-3 years; +3 years). The independent variables are explained in Table 2. Each coefficient T-statistics is in brackets and *, denotes significance at 5 percent level.

Independent Variables	Real sales		Employment		Dividend to Sales	
	Fixed Effects	Random Effects	Fixed Effects	Random Effects	Fixed Effects	Random Effects
CONSTANT	0.003 (0.014)	0.055 (1.221)	0.002 (0.015)	0.007 (0.028)	0.001 (0.001)	0.004 (0.254)
INVEST	1.766* (1.482)	1.965 (1.455)	2.659* (2.565)	2.986* (2.776)	-0.004 (-0.056)	-0.101 (-0.022)
ASSETS	1.757 (1.532)	2.040 (1.604)	1.232 (1.776)	1.734 (1.432)	1.389 (1.022)	1.102 (1.101)
TOTAL DEBT	0.454 (0.545)	1.094 (1.367)	0.122 (0.178)	1.005 (1.016)	-1.232 (-1.112)	-1.108 (-1.203)
GDP	7.565* (6.889)	9.776* (8.778)	6.305* (4.505)	9.452* (8.777)	4.210* (2.883)	6.334* (3.045)
SHAREHOLDERS IN MANAGEMENT	5.676* (4.678)	6.656* (5.434)	-0.012 (-0.297)	-0.676 (-0.143)	2.343 (2.667)	2.776* (2.756)
CONCENTRATION AFTER THE IPO	3.403* (2.565)	4.787* (3.676)	-0.202 (-0.101)	-0.378 (-0.209)	1.567 (1.224)	2.112 (1.366)
PARTIAL IPO	1.587 (1.761)	1.901 (1.347)	1.676 (1.787)	2.798 (1.766)	1.969 (1.130)	1.112 (1.287)
CEO	3.177* (3.662)	5.474* (5.707)	1.755 (1.444)	1.546 (1.343)	2.978* (2.788)	3.121* (3.533)
Nobs	92	92	92	92	92	92
Tests						
F	2.54	1.86	4.22	2.44	4.55	3.66
Hausman	0.66	0.78	1.33	1.10	1.21	1.14

* rejection of H0 at five percent level of significance

In spite of a decline in post-issue profitability, relative to their pre-IPO levels, our results show that firms, after going public, exhibit an increase in *real sales*. That is, the declining profitability of IPO firms can not be linked to a lack of sales growth, because, in general, sales increase after the IPO. However, there are a number of factors that are determinant to the rising of sales. First, our real sales panel regression provides evidence that the amount of national wealth (GDP) and its growth, for a certain period of time, has a very significant positive relation with sales increase after firms going public (see Table 3b).

In addition, another important factor is the presence of shareholders in management. In fact, when shareholders are present in the Board of Directors, sales growth is much more pronounced and significant than if they were not inside the Board, probably, because, by this way, shareholders can make commercial and marketing decisions to increase sales that were not possible if they were not inside the Board of Directors. Another conclusion from our data is the relation between equity concentration and sales increase. In fact, after family firms had gone public, when sales tend to increase, there is an equity concentration in one or a few group of shareholders. That is, the closely-held companies with more

concentrated structures are more successful, showing an improved operational and financial performance. All these and other results can be observed in Table 3b. Both models, (random and fixed effects) present similar tendencies and, in general, about the same coefficients. Investment appears to be one of the most significant variables to explain changes in *employment* after going public; as a matter of fact, our panel regression tests for employment at five percent significance level, presents a positive relation with investment expenditure. This relationship means that as investment (expansion or modernization) increases, companies need more employees to work with the new machinery, new equipments, and new technology environment. Our empirical results confirm some of the expectations about employment of several authors, such as Jain and Kini [1994]. In addition, another positive relation with employment is the economy health during the years after companies going public.

On the contrary, we have results of negative relations between certain coefficients and employment. This is the case of shareholders in management that tend to show a negative relation with the number of employees after going public. We may conclude from here, that shareholders in management, probably, wish to cut costs, as personnel

costs, in order to add value to the company. The same happens with the equity concentration. All these and other results can be observed in Table 3b.

When testing the explanation for *dividend policy* changes, fixed and random effects models show nearly similar same results. First, our regression tests show as a positive relation with economic growth. When the economy is growing, firms tend to be more profitable and, therefore, firms show more conditions to increase their payout ratio. Keeping the same CEO after going public and when shareholders are in management, seem to be two positive conditions to impact the dividend policy of the firm. That is, when CEOs stay in management and when shareholders are directly present in the Board of Directors, the payout ratio tend to be higher due an improved operational and financial performance, that is, due to an increased profit. Simultaneously, we observe negative relations of Dividend Payout Ratio with debt. This may be the result of the development of new projects after going public. In other words, when companies present a high level of debt, the consequence is a more restrictive dividend policy. All these and other results can be observed in Table 3b.

When testing the reasons why *activity level* changes after IPOs, we find a negative influence of

firms in sales in relation to total assets on the additional activity degree. That is, lower activity levels mean less efficiency, losses of productivity and firms use relatively more production factors (labour and capital intensive), to produce and sale the same, becoming less competitive. Shareholders in management after firms going public, is another determinant that causes a more professional and efficient management, with positive consequences on the operational performance of firms after going public. An explanation is in the presence of stockholders in the management team, that gives the other members of the Board of Directors, an additional motivation to develop a more professional management. Equity concentration also has a positive impact on activity levels and, in consequence, on the economic performance of firms after going public, since, under these circumstances, with a strong equity concentration in the same owners, some important management decisions can be taken in a more easy way. By last, the permanence of the same CEO also has a positive impact on activity levels and efficiency, due to his own knowledge of the firm and its business and procedures. All these and other results can be observed in Table 3c.

TABLE 3c. Results of Panel Data Estimations: Activity levels, Short term equilibrium, and Capital structure

This table reports the estimates of panel data estimations for operating income of the 25 closely-held firms that went public for the pre and post - IPO period (-3 years; +3 years). The independent variables are explained in Table 2. Each coefficient T-statistics is in brackets and *, denotes significance at 5 percent level.

Independent Variables	Activity levels		Cash and Banks to Short Term Debt		Total Debt to Total Assets	
	Fixed Effects	Random Effects	Fixed Effects	Random Effects	Fixed Effects	Random Effects
CONSTANT	0.033 (0.022)	0.011 (0.012)	0.001 (0.002)	0.004 (0.008)	0.002 (0.033)	0.003 (0.073)
INVEST	-0.144 (-1.383)	-0.177 (-1.454)	0.009 (0.004)	0.103 (0.101)	1.019 (1.128)	1.210 (1.209)
ASSETS	-3.868* (-2.848)	-4.238* (-3.949)	0.103 (0.277)	0.155 (0.299)	-3.838* (-3.433)	-4.756* (-4.766)
TOTAL DEBT	0.003 (0.012)	0.005 (0.022)	-2.454* (-2.855)	-3.575* (-3.565)	9.030* (7.858)	13.959* (8.747)
GDP	2.867* (2.767)	2.747* (2.949)	2.787* (2.699)	3.887* (3.877)	1.294 (1.088)	1.002 (1.066)
SHAREHOLDERS IN MANAGEMENT	2.588* (2.505)	3.398* (4.389)	1.655 (1.485)	1.667 (1.479)	2.928* (3.829)	3.838* (3.747)
CONCENTRATION AFTER THE IPO	3.856* (2.599)	4.878* (2.997)	2.657* (2.466)	3.335* (3.577)	2.202* (2.767)	2.989* (2.828)
PARTIAL IPO	1.102 (1.490)	1.788 (1.258)	1.503 (1.232)	1.343 (1.676)	2.575* (2.748)	3.928* (3.424)
CEO	2.476* (2.523)	2.356* (5.786)	1.978 (1.676)	1.877 (1.887)	2.535* (2.944)	3.736* (3.838)
Nobs	92	92	92	92	92	92
Tests						
F	4.8	3.7	3.5	3.4	4.4	5.7
Hausman	1.1	1.8	1.2	1.8	2.2	2.3

* rejection of H0 at five percent level of significance

We employ Cash and Banks to Short Term Debt (CBTSTD), to test for changes in the *short term equilibrium* after firms going public. The total debt seems to have a negative influence on the short term equilibrium, that is, there are no performance improvements after firms going public, at least on the

financial side. This result in the financial side of the firm is a consequence of what happen in the economic side, that is, firms after going public, with a lower performance in their profitability, efficiency and activity levels, necessarily have negative consequences in their financial structure, which

means a weak short term equilibrium. The variable GDP is positively related with short term equilibrium, meaning that this financial indicator is directly dependent on the financial wealth of the economy. Necessarily, when the economy is growing, it pushes up firms to increasing business, namely sales, what conducts firms going public to a better operational and financial performance. All these and other results can be observed in Table 3c.

Finally, we studied *capital structure* changes after firms going public. We employ Total Debt to Total Assets (TDTA), to test for changes in the capital structure. Our panel data tests show that the economic wealth of the economy and its growth is a very relevant cause for explaining changes in the capital structure level following privatization. The GDP level in the economy is significantly positive related to the financial wealth of the firm and to its capital structure. We observe that the total debt independent variable, present a significant positive coefficient related the currents liabilities; on the contrary, the total assets present a negative relation with capital structure.

This deterioration on the capital structure of the firm is a consequence of a decrease in profitability, efficiency and activity levels. This lower performance, as far as the operational and economic side of the company is concerned, necessarily conducts the firms going public, and to a weaker capital structure than it was before them becoming public. The equity concentration in a few shareholders after the IPO, the existence of shareholders in management after going public and the partial IPO have a positive influence on the capital structure of the firm. All these and other results can be observed in Table 3c.

7. Summary and conclusions

Over the last two decades, the process of going public through an Initial Public Offering or Direct Sale has been developed and, nowadays, many firms are no more family, closed-held firms. An initial public offering raises very relevant problems – most of which are, as yet, not completely answered. There is some evidence, Jain and Kini [1994] that, by the process of going public, IPO firms decline its operational and financial performance but, at the same time, those firms present evidence of growth in sales and in the capital investment and total assets. While there is no relevant empirical evidence about the financial and operating performance behaviour of closely-held companies after they go public, to date, there is very little investigation about the causes, the determinants, why certain performance behaviour occur. Consequently, this work looks for some evidence regarding the sources of certain financial and operating performance behaviour of those family companies after they go public. Our study is the first to make the following contributions:

In first place, it is the first empirical work developed in Portugal, for closely-held (family) firms,

to empirically examine *why* and how the process of going public works, to investigate *which* are the some of the principal determinants for those operational and financial performance. In second place, we do not limit our investigation to initial public offerings (IPOs), since we also include on our study several companies that went public by direct sale or public contest. In third place, our database includes information about Portuguese closely-held firms IPOs from 1989 to 2004 for 25 (twenty five) companies. For that reason, our data span a larger time period than any other study of this nature, and we feel that our findings are especially valuable because our database allows us to undertake the single most thorough multi-sector, multi-industry of the determinants of family firms that go public. In other words, this investigation looks for some answers regarding the sources, the causes, and the starting point of the operational, social and financial performance of family companies that went public in the past. The most relevant determinants of post-privatization operational and financial improvements are presented in the following paragraphs.

There is not a consensus on existing research about the consequences for firms that go public, as far as the operational, social and financial performance is concerned. The results are mixed as already mentioned on the literature review. For all that found that there is a decline on profitability and sales, such as, Anderson and Reeb [2003], Singh and Davidson III [2003], Jain and Kini [1994] and others, there are a few explanations for the drop in profitability and efficiency. One of them is related with accounting brought by the decision to go public. During the preparation of their accounts for the IPO, several companies try to provide a fair picture of the value of their assets. As a consequence, the value of the assets may be overvalued before the IPO. Other explanation for the decline in profitability is based on the adverse selection theory (companies go public when profitability is about to decline in a permanent way) or moral hazard theory (controlling shareholders have a great incentive to get special benefits). Consistent with the adverse selection and the moral hazard explanations, Pagano [1993] found that the decline in profitability after the IPO is negatively related to the change of the incumbent's stake at the IPO.

Apart those findings and explanations, our conclusions are very closed to those authors mentioned before. However, as we said above, we looked for the causes, for the determinants that explain that kind of performance. Our work concluded for the following determinants: in first place, the number of shares sold by the founding owner is a crucial determinant to explain changes on the operational and financial behaviour of the new public firms. A partial IPO with large amounts of stock retention by the family owners proves to be a better solution in terms of performance than it is a total IPO, where the majority of stock is sold to public investors. As a matter of fact, if we talk about a partial IPO (less

than fifty percent), the founding owner keep takes his own management and main management positions, results that are very closed to Jain and Kini [1994].

Secondly, the existence of management ownership is one of the most important factors that affect the firms' performance after going public. There is a potential for increased agency costs when a firm chooses the public ownership. The reduction of management ownership that occurs when a firm goes public, normally, leads to agency problems, according to Jensen and Meckling [1976]. In spite of the transaction, the presence of some shareholders in management, not only attenuates those agency conflicts, but also, this mixed management structure gets better performance results than management structures without shareholders. Our findings are much closed to those of Singh and Davidson III [2003] who found that higher managerial ownership significantly and positively influences the corporate asset utilization efficiency and it acted as a significant deterrent to excessive discretionary expenses.

In third place, our study appoints to a very important determinant of performance behaviour after the IPO: the maintenance of the CEO after going public. If this happens, the results are substantially better, probably because the hypothesis of a new hired CEO has several implications on performance. They concluded that family firms, with hired CEO or family member, without changes at this level, exhibit superior firm performance relative to no family firms with CEO changes. The new CEO takes time to get all the information to run the new public company with the best conditions: knowledge of the business, the sector, the people, the systems, etc. Our conclusions on performance of firm that change or do not change their CEOs after going public are similar to those presented by Anderson and Reeb [2003].

In fourth place, the real output empirical tests provide evidence that the amount of national wealth (GDP) is a crucial determinant, it has a very significant positive relation with pos-IPO operational,

social and financial performance, leading, in particular, to a real output increase. During the period under analysis, it was demonstrated that economic health conducted to better results for the new public firms.

In fifth place, it was demonstrated that equity concentration is a very crucial determinant of firms after going public. Firms with a more concentrated equity structure perform better than firms with a more dispersed structure. Companies with a large number of dispersed shareholders have little incentive to control. Large shareholders diminish the agency problem since ownership and control are separated. Our findings are similar to those as defended by Morck *et al.* [1988].

In short, when closely held (family) companies go public, in general, profitability, efficiency and activity levels decline. In spite of these operational findings, output and investment normally grows. On the social side, employment decreases after the going public process. In addition to the operational aspect, on the financial side, we see that debt may decline during the period after the IPO. Also, the financial equilibrium of those firms is negatively affected, partially explained by the poor performance on the economic and operational side. However, there are causes, determinants that influence these findings. That is, under certain conditions, after the IPO, these performance directions can be modified or minimized. This happens when certain conditions are verified after firms going public, IPO or direct sale, which we consider the causes, the determinants of the operational, social and financial performance, as follows: when shareholders are represented in management, when there is a significant equity concentration in one or in a few shareholders, when the old CEO stays on charge, when total debt declines, when the economy is in a good shape and when there are several investment projects under development.

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THE ROLE OF SOCIAL NORMS FOR THE RELATIONSHIP BETWEEN PRIVATE OWNERSHIP AND THE PERFORMANCE OF BANKING SECTORS IN TRANSITION COUNTRIES: THE CASES OF BULGARIA AND HUNGARY AS EXAMPLES

Ingrid Gröbl*, Nadine Levratto**

Abstract

We start with a theoretical reflection on the merits of private ownership in banking sectors concluding that the merits of private ownership in a market economy crucially depend on the overall compliance with principles of good governance. We show that it is pivotal in this respect that the underlying legal order is in action and not just on the books. Whether this is the case depends on accepted social norms which in their turn derive from cultural value orientations. We use these insights to compare the development and performance of banking sectors in Bulgaria and Hungary with the attempt to establish relationships of found differences between the countries to different basic value orientations.

Keywords: private ownership, banking sector, transition countries, Bulgaria, Hungary

* University of Hamburg

** École Supérieure de Cachan

1. Introduction

Private ownership is widely accepted as the heart of market economies. Private owners possess the right to alienation setting them incentives to choose actions which promise to enhance the value of their assets thus contributing to aggregate welfare, too. It is also widely accepted that banks pose no exception to this rule, and indeed even in Germany, where public ownership in the banking sector used to have a long-standing tradition, restructurings towards minimizing the ratio of public banks are under way. It is therefore not astonishing that the privatization of socialist financial and non-financial firms together with the creation of new private firms has been considered as pivotal to successful transition. Advocates of the Washington Consensus even held the view that privatization combined with stabilization policies implementing hard budget constraints would be sufficient to pave the way towards flourishing market economies. From the very beginning it appeared obvious that banks would have to play a crucial role in financing necessary restructurings and investments in the business sector. Contrary to banks, organized financial markets were absent, and it was clear that it would take years for them to develop. A major problem of the socialist banking sector was its lending practice which followed political criteria and in this respect regularly violated principles of prudence and efficiency. It appeared quite logical to identify this malfunctioning of socialist banks with state ownership which lead to recommend swift privatization. Looking back at the more than 15 years which have passed

since the demise of Communism, we observe that privatization was neither a fast happening event, nor did it prove to be a panacea. We moreover observe remarkable differences between transition countries as regards the speed at which private ownership took over, the modes of privatization as well as economic consequences. The large number of empirical works focusing on the role of privatization confirms that in particular the type of owner with its significant impact on governance, has played an important role for the success of privatization activities (Frydman et al., 1999; Crotty et al., 2004). However, the investigations also emphasize a role of the legal order and its enforcement in general and with respect to banks, the regulatory framework in particular. In our paper we take up this issue. Based on theoretical reflections we show that the merits of private ownership are crucially dependent on the overall compliance with *principle of good governance* like the rule of law, transparency together with accountability and the absence of graft (corruption and fraudulent practices) which – provided that they are honoured in corporations as well as in the political and judicial sphere – constitute the pillar of a well-functioning market economy in general and a stable and efficient banking system in particular. The rule of law can be considered to be pivotal in the sense that whenever this rule is absent, it can hardly be expected that judges will pose an exception implying that accountability will hardly be observed and corruption will flourish. Transition countries have revealed a considerable reluctance of governments to implement laws prescribing good governance. But even if the required legal institutions

were brought on the way, they often remained on the books (Gray, 1997; Pistor, 1999). The missing link between law on the books and law in action has been found to be *informal institutions*, i.e. rules which cannot be legally enforced but rely on informal sanctioning mechanisms like loss of reputation, ostracism or feelings of guilt. In our paper we elaborate the hypothesis that in this respect, *injunctive* informal institutions which in a society prescribe what ought to be considered as good and bad, play a crucial role – to be called “social norms” henceforth¹¹ – play a crucial role. More precisely we follow Licht (2004) stating that social norms do not appear in isolation but rather are interrelated to form a system. Such a system of social norms constitutes a pyramid standing on top with fundamental norms on a very general level giving rise to more and more concrete social norms governing everyday social interaction (Licht, 2004). These fundamental social norms which can be interpreted as basic cultural value orientations will be shown to play an important role for the relationship between private ownership and the performance of banking sectors in transition countries. In this respect we have found that Hungary and Bulgaria constitute contrasting examples.

For the remainder of the paper we proceed as follows. After having specified the requirements for the superiority of private ownership in banking sectors thus clarifying the role of overall governance structures, we make the relationship between governance structures and basic cultural value orientations more concrete. In particular we make evident which value orientations foster the evolution of governance principles like the rule of law, accountability and the absence of graft. We then turn to Bulgaria and Hungary studying the performance of their banking systems in relation to private ownership. Since we devote much space to more interdisciplinary issues we do not intend to provide a careful econometric analysis as regards the relationship between private ownership and popular indicators of banking systems’ performance like the degree of concentration, rate of return on equity, capital adequacy ratio and the like. Rather, in this respect we resort to the manifold studies which already exist.

2. The Merits and Limits of Private Ownership for the Performance of Banking Sectors

2.1 Some Reflections on the Role of Private Ownership in Market Economies

When students of economics learn about the advantages of a market economy, they are very

quickly confronted with the General Equilibrium Model (GEM). Its basic message is that in a world of perfect information aggregate welfare can be maximized provided that property rights which entitle individuals to decide on scarce resources are completely specified and tradable through a price mechanism in perfectly competitive markets. A maximum of aggregate welfare is characterized by Pareto efficiency which implies that individuals achieve a maximum of utility by the choice of waste-avoiding production strategies and by the exclusion of personal enrichment at the cost of others. The upshot is that in such a world the type of property right, i.e. whether individuals have the right to just use resources or in addition to modify and sell it, is irrelevant. Differently put, it does not play a role whether ownership of scarce resources is individually or collectively held; private ownership hence has no special merit in a GEM world. The GEM describes the ideal of a market economy which provides every economic actor with the capacity to exercise choice, and ensures that social interaction is marked by exchange which implies that trading parties meet each other at eye level. This is equivalent to saying that *power relations* i.e. relations that provide one trading party with the capacity to exercise choice at the expense of the other party are absent. It should not be overlooked that this view tacitly assumes away, that even in the GEM world there exist power relations which basically follow from the physical superiority of some individuals over others. Hence, perfectly competitive markets and perfect information will not rule out theft through the use of physical violence. Connected to this, nothing- at least not explicitly - is said about a widely observed inclination of market participants to form coalitions thus obtaining the power to turn competitive into concentrated markets. How power relations are structured, is now debated under the term “governance” (Kaufmann et al., 1999, Hellmann et al., 2000). The GEM *tacitly* contains governance principles which make sure that individuals do not abuse power or even refrain from acquiring power as such. These governance principles forbid agents to violate agreements, to steal others’ property rights, and they tell them to acknowledge the price mechanism as the exclusive coordination mechanism thus abstaining from graft and other strategies that allow to achieving market power and thus the power to dictate prices.

If we leave the GEM world, power relations increase in importance. Their major origin can be found in information deficits. In this respect information asymmetries and transaction-specific investments which are not contractible due to unforeseen or indescribable future contingencies play an important role. Now agents with superior information as well as a trading party who has not invested into a contractual relationship whereas the other party has done this, are endowed with (bargaining) power which they can use in an opportunistic manner thus redistributing wealth.

¹¹ As is elaborated in Licht (2004), there exist manifold definitions of social norms. The definition we have chosen serves to distinguish injunctive informal institutions from mere habits but also as will be explained below from rules which are followed out of mere self-interest (Elster, 1989).

Information asymmetries as well as non-contractible transaction-specific investments are at the core of property rights theory which emphasizes that it is in particular in these cases where private ownership becomes crucial (Hart et al., 1990). As an example consider an agent who has been given the right to use a factory but not to sell it, i.e. on the one hand he does not profit from selling the factory after it has gained value but on the other hand he also does not bear losses due to value destroying actions. In a world of perfect information a principal who possesses the right to alienation will be able to prevent his agent to whom he has delegated the right to use the asset, from taking choosing-destroying actions. However, in a world of information asymmetry this is not that easy. Monitoring is costly and costs may even be prohibitive. Hence the user of the factory might have an incentive to use up the factory, and he might be indifferent with respect to value destructions. In contrast an owner-manager will have a clear-cut incentive to choose strategies which promise to be value-enhancing and he will be accountable for losses due to expectation errors. In the same way property rights theory has shown that whenever social interaction requires one party to engage more heavily in transaction-specific investments which cannot be contracted upon initially, this agent should own the underlying asset to which the investment adds value (Williamson, 1975). It is important to recognize that the described merits of private ownership depend on existing well-functioning markets for ownership rights. Only then will market participants price firm assets according to their "true" value setting owner-managers incentives to choose investments with positive present value. Given a system of perfectly specified property rights which allows to avoiding externalities, investments which are value-enhancing at a firm level increase aggregate welfare, too and thus contribute to Pareto-efficiency. This model indeed constitutes the backbone of the Washington Consensus which has put privatization into the centre of transition strategies.

Given information asymmetry and transaction-specific investments which cannot be contracted upon, private ownership *prevents* the creation of a power relation held by the mere user of an asset which could be exploited in a Pareto-inferior manner. However, a word of caution is in order here because private ownership gives rise to new power relations which can be abused in a welfare deteriorating manner. In these power relations, the owner himself may possess power for basically three reasons: First, malfunctioning markets for ownership, second the existence of debt as a financing device, third transaction-specific investments by other stakeholders. Turning to the first argument, it has to be taken into account that information asymmetry as a widespread phenomenon will guide the behaviours of market participants, too. In particular those possessing superior information will have the power to exploit others for example by revealing false information.

Potential buyers of a firm facing high screening costs may be unable to verify a firm's true quality. Hence market prices may be distorted leading to Akerlof's lemon problem (Akerlof, 1970). The second reason accounts for the fact that under information asymmetry it also plays a role how private ownership over physical assets has been financed (Jensen et al., 1986). Private ownership of firms for example does not require that firm-owners have used their own financial funds to finance machinery and other assets. Money can be borrowed, and owners might abuse information advantages compared to their lenders in order to select excessively risky projects. The third reason deals with implications of specialization. In a world of specialization, in particular owners of firms will have to employ workers whose income depends exclusively on their human capital and who have to undertake firm-specific investments which cannot be verified by third parties thus being locked into the firm. The same is true for locked-in suppliers or customers.

The above stated arguments support the view that under information asymmetries and transaction-specific investments, private ownership conveys power to the owner himself. However, it is also true that owners may be the addressees of expropriation. For example the enforcement of private ownership rights might be ineffective. This is the case if contracts concluded with suppliers, customers, employees, financiers are not honoured and if the courts lack material independence. A further point which gave rise to a large body of literature is related to the fact that in modern economies it is common for owners to delegate property rights to managers who – as insiders – gain superior information. In this case a low degree of concentration of ownership i.e. widely dispersed ownership may expose every individual owner to excessive monitoring costs leading to a free-rider problem and thus sub-optimal monitoring. But even with concentrated ownership problems arise since even a large owner will be an outsider being exposed to residual information disadvantages (Shleifer et al., 1997). In this respect it has also been found that a market for corporate control may fail for the same reasons that set managers incentives to choose value-destroying actions. Indeed, managers with superior information can use this advantage to offset the disciplinary effects of the price mechanism in markets for corporate control. Hence the malfunctioning of private ownership and the malfunctioning of markets are closely interrelated in the sense that better market mechanisms will hardly be achieved without solving information asymmetry problems.

We may therefore conclude that private ownership as such does not guarantee Pareto-efficiency in a world of information problems, and indeed private banks were upon the prominent actors triggering off banking crises and credit crunches as well.

In the following we show that the relative success or failure of transition countries is closely related to their successful overall establishment of principles of good governance thus ensuring the necessary conditions for welfare-enhancing contributions of privately owned firms. In order to guarantee overall good governance, a system of checks and balances is needed which rests on the following pillars: first, division and separation of powers which implies that legislation and the execution as well as the enforcement of laws are separated, second, a legal system that specifies personal freedoms, imposes constraints in a unanimous manner and provides legal enforcement mechanisms. Third, a political system allowing that politicians can be voted out of office if they do not perform their tasks. Fourth, a private sector which accepts the democratic order and its major institutions as guides of behaviour. It is important to recognize that a formal apparatus based on legal norms, i.e. law on the books, will not suffice. Law has to be in action, and in order to achieve this, democracy has to be accepted as a societal consensus which as we shall see below is deeply rooted in inherited cultural values giving rise to a particular set of social preferences and social norms. The disciplinary role of the market, too, is limited if this societal understanding does not exist because economic agents possessing power will offset these mechanisms in their favour.

Private Ownership in the Banking Sector

The existence and special merits of private banking institutions and bank credit in particular, too, has been associated with information asymmetries and non-contractible transaction-specific investments. Following the academic literature, banks as an element of financial systems owe their existence basically two reasons: first a missing ability of savers to verify the true performance of their debtors (Diamond, 1984) and second, contractual incompleteness due to failures of the legal system or unforeseen and indescribable future contingencies which exclude legal enforcement (Rajan 1998). Following Diamond, Rajan (1997), the details of the relationship between the bank and its clients – debtors and depositors as well – are important in this respect. These details are marked by noncontractual mechanisms like a bank's investment into reputation (Book, Greenbaum, and Thakor 1993) due to the insight that a bank engages in the same business many times, or its investment into keeping a borrower as a client (Petersen et al., 1995, Diamond and Rajan, 1999). Borrowers, too, might have an incentive to building a reputation for honouring their obligations. Private enforcement of loans is then promoted by enduring relationships between banks and their borrowers marked by mutual endeavours to keep their reputation. Both strands of research reveal that banks serve to enhance economic growth by overcoming information problems which might imply misallocations of financial funds.

Implicitly the study of banks as financial intermediaries assumes that banks are privately owned with owners having an interest in enhancing the value of their banks. And indeed at least on the microeconomic level empirical investigations assign to privately owned banks a higher performance than state state-owned banks. (Barth et al., 1999; Sapienza, 2002). However, banking sectors have been regularly plagued by banking crises and at least for industrial countries there is no evidence that state-owned banks have played a superior role in triggering off these crises. Levine (2004) emphasizes that banks give rise to corporate governance problems which are more pronounced than in non-financial firms. In this respect he emphasizes the role of opaqueness which aggravates problems associated with information asymmetry and which Levine has found to be higher in banks than in non-financial firms. Into the bargain comes the fact that a bank's major creditors, i.e. the depositors are widely dispersed lacking both the capacity and willingness to engage in intensive monitoring processes. Whenever the bank and depositors follow different objectives, the bank can use its information advantage to ignore depositors' interests. This is in particular the case if either the bank-owner-manager is not fully liable or if bank-managers do not fully participate in losses. Then moral hazard might follow leading to the accumulation of bad credit risks which may lead the economy into banking crises. On the other hand information asymmetries might render the rationing of credit to high-quality borrowers to be a value-maximizing strategy thus contributing to declining GDP growth. Also as Prowse (1997) has found hostile takeovers tend to be rare in banking sectors which, too, is closely related to opacity implying that the information advantage of bank insiders is more pronounced than in non-financial firms.

Reputation which has been emphasized as a major reason for the rise of banks in an environment marked by weak legal enforcement, is not a natural outcome of private ownership (Rajan, 1998). As is shown in formal models assuming rational egoists (Shapiro 1993; Kreps, 1990), a value maximizing agent has an incentive to build reputation if this promises a positive net value which exceeds the immediate benefits of cheating. This in turn requires that the number of repetitions is unknown, that the bank's subjective time preference is sufficiently low and that the prices for financial services are sufficiently high which conflicts with a high degree of competition. As a further implicit assumption the formal models take for granted that buyers, for example bank clients do not face high exit costs thus being able to quit a bank after having made bad experiences. Bank credit, however, typically involves a bank-borrower relationship with significant exit costs above all for the borrower. The bank has the capacity to exploit its advantage and increase the interest rate or claim further collateral driving borrowers into insolvency.

Indeed, banking crises in which bad bank governance plays an important role have been a widespread phenomenon not only in developing, emerging or transition countries. Since the banking crises of the 1930s a dense network of regulations and more recently increasing supervision has spanned financial systems in general and banks of Western industrialized countries in particular with the major purpose to improve bank governance on behalf of financial institutions' soundness and financial system stability. However, regulation and supervision constitute further governance problems. As Llewellyn (1999) emphasizes, the relationship between regulators and regulated financial institutions constitutes a principal agency relationship marked by information asymmetries which can give rise to opportunistic behaviour on the part of the better informed banks thus undermining the intention of prudential regulation if monitoring procedures are without success. Regulators or supervisors on the other hand might give priority to their personal objectives thus being concerned about their personal career and in this respect future job prospects in the private sector in general or banking sector in particular. "Regulators may be "captured" by the industry they are supposed to oversee" (Chami et al, 2003: 15). It is now increasingly accepted that the soundness and stability of the banking sector is a problem of *overall* governance (see Llewellyn, 2000 for a conception of regulatory regime and Das et al, 2004 for the role of Basel II in this respect). Overall governance is meant to describe practices which are accepted by all participants of the banking systems, i.e., regulators as well as banking institutions but also firms and beyond that the broader public sector. Das et al (2004) use the term "government nexus" in this respect to describe the impact of government practices at each layer – government, supervisors, banking institutions and the corporate sector. Again independence which is closely associated with the rule of law, accountability and connected to this, transparency and integrity as well as the absence of corruption are appealed as principles of good governance which contribute to well functioning banking sectors in private ownership (Das et al., 2004).

Principles of Good Governance and Social Norms

It is a main hypothesis of this paper that the merits of private ownership depend on its integration into a democratic order which is "in action" and not only "on the books" thus giving rise to a general acceptance of principles of good governance. In this respect, the interplay between legal and social norms gains importance. In accordance with Licht (2003 and 2004), Elster (1989), Fehr and Gächter (2000) and similarly Ostrom (2000) we define social norms as rules which are based on a shared belief on how one ought to behave in particular situations and which - contrary to legal norms - depend on effective *private*

enforcement mechanisms like the loss of reputation despise by others, ostracism or feelings of guilt or shame. The major point is that social and legal norms are not independent, and that in particular widely accepted social norms have a crucial impact on the formation of legal and political institutions itself as well as on the degree to which a given legal and political order is accepted. If legal and social norms are complementary, then the legal order will be widely accepted with the consequence that law is in action. This does not only imply that the courts are factually independent but also that private enforcement mechanisms may even replace legal enforcement (law then becomes expressive, cf. Cooter, 1998). We may go a step further in this respect stating that social norms have a major impact on whether *principles of good governance* are on the books only or in action. Take the rule of law as an example. Of course a system of legal enforcement mechanisms can be established in favour of a society's compliance with this rule. However, this will be of little use as long as the courts lack factual independence. One could attempt to establish judicial independence by help of legal sanctioning mechanisms, too. However, in a society marked by a consensus that it is neither necessary nor desirable to abide by the law, this will not be very fruitful. This implies that the rule of law is sustainable only if this rule constitutes a social norm itself (Licht et al., 2003) or is the outcome of the more general social norm to honour agreements. In the same vein accountancy/voice and the absence of corruption as a government principles will survive only if social norms exist that prescribe individuals to comply with principles of truth-telling, fairness and reciprocity

There is a growing literature focusing on the issue how social norms evolve and which factors induce compliance with them. Experimental studies are concerned with the role of deviations from rational egoistic behaviour in promoting collective action.¹² Following Kreps (1997), theoretical approaches can be classified into external and internal views. According to an external view social norms impose constraints on individual behaviour which are binding due to effective sanctioning mechanisms like the loss of reputation. This approach has been developed within the framework of game theory¹³. For example in Bowles et al. (1998) it is derived that social norms like truth-telling, fairness, reciprocity, honouring one's commitment have a high probability to develop in small communities where social interaction is marked by high exit and entry costs rendering a high frequency of interaction and a correspondingly high probability of meeting the same trading partner again. Given such a setting, costs of information will be low and the probability that uncooperative behaviour is

¹² For an overview cf Ostrom (2000).

¹³ Increasingly norms are investigated within the framework of evolutionary games, cf. Binmore (1998), Skyrms (1996), Bicchieri (1997).

retaliated, will be high. Both, low cost of information and a high probability of retaliation imply that the immediate benefits of defecting are significantly outweighed by high future benefits of building up a reputation for cooperative behaviour. Given this, high exit and entry costs tend to reinforce the information and retaliation effect rendering truth-telling and an inclination to cooperate as social norms providing a set of stable and widely shared expectations about other actors' willingness to behave well (Shapiro, 1983; Axelrod, 1984; Gintis, 1989; Kreps, 1990; Bowles et al, 1997) Unfortunately the external view leaves unexplained how social norms in *large* communities evolve and are enforced where the degree of anonymity is high and where subgroups are common implying that one group may develop norms which subordinate other groups. (Cooter, 2001) Beyond that reputational equilibria are far from being robust with respect to changes of exogenous conditions thus implying that social norms are highly fragile. This contradicts the empirical finding that social norms are rather sluggish as regards their adjustment to a changing environment. Indeed as Jon Elster (1989) describes it, approaches based on rational choice view economic agents as guided by the prospect of future rewards always willing to modify behaviours in light of new information about cost and benefits. In this respect norms derived in a game-theoretic framework share a great resemblance to what Robert Sugden (1989) denotes as conventions whose survival depends on whether they promise a substantively better outcome for the players.

Alternatively, internal views locate the components driving compliance with social norms within the individual person thus shaping individual preferences (Licht, 2004). Whereas the external view explains the evolution of new social norms and compliance with prevailing norms with cost-benefit considerations¹⁴, the internal view rests on endogenous individual preferences with the social environment being a major determinant. Social norms regulate human activities with the purpose to establish a social order by specifying behaviours which are accepted as desirable and by providing private enforcement mechanisms which include emotions like feelings of guilt (Licht, 2004; Rutherford, 1991). Endogenous preferences play a role in the Old Institutional Economics as well as in evolutionary economics¹⁵. These literatures doubtlessly offer interesting insights into the evolution and enforcement of *particular* social norms derived in isolation. However, social norms rarely appear in isolation but rather constitute a system in which norms are related to each other. This directs the question of what determines a particular norm to the question of raises of what determines a particular *structure* of prevailing

norms. With respect to transition countries this implies that the development of social norms fostering good governance might be hindered because these norms do not fit into the inherited structure of social norms. We think that in this respect cross-cultural psychology offers some interesting insights which can be applied to explaining both institutional impediments to economic transition as well as country-specific differences in this respect.

According to cross-cultural psychology every society is encountered with basically three issues: The first question concerns the relationship between the individual and the group or society as a whole. The second question is about how responsible behaviour can be ensured thus that the social fabric can be sustained. The third question concerns the relationship of humankind to the natural and social world. (Schwartz et al. 1995: 97). Following Licht (2004) the answers given in a society give rise to a pyramid of social norms meaning that social norms are interrelated and that norms can be distinguished according to their importance. This pyramid of social norms stands on its head since only a few fundamental social norms constitute its basis in the sense that any other social norm which is accepted in a society is derived from these fundamental rules. In cultural psychology these fundamental social norms are referred to as *cultural value dimensions* which describe societal preferences as regards the way how the relationship between the individual and the society should look like, how social interaction and the relationship between humankind and the natural and social world should be regulated (Shalom Schwartz (1992, 1995) and Geert Hofstede (1980, 1997, 2001).

The first issue concerning the individual and the society leads to two contrasting value pairs denoted as "autonomy" versus "embeddedness" by Schwartz and "individualism" versus "collectivism" by Hofstede. "Autonomy" or "individualism" denotes a cultural value that attaches to individuals a high degree of autonomy with respect to the choice of their personal goals and the ways to achieve them. Individuals are valued as human beings that are conscious of their uniqueness. According to "embeddedness" or "collectivism" individuals are valued and value themselves as members of a social group which means that they identify themselves with the social network they belong to. Notably this social network goes beyond the boundaries of the nuclear family or kinship. Group solidarity and unquestioning group loyalty are undisputed. The second question concerns ways how individuals can be induced to consider the welfare of others, thus retaining the social fabric. Again the answer is seen to depend on entrenched cultural values where now "hierarchy" versus "egalitarianism" in the terminology of Schwartz or the degree of power distance in the terminology of Hofstede constitute contrasting cultural values. Hierarchy as a cultural value implies a societal order which relies on large power differences, i.e. hierarchical systems of ascribed roles. As Schwartz

¹⁴ Therefore Rutherford (1991) denotes norms which are based on rational choice as conventions.

¹⁵ An excellent introduction is provided in Bowles (2004).

(1995:96) describes it “People are socialized and sanctioned to fulfil their roles, the roles define social obligations, and acceptance of the hierarchical order assures compliance with the rules that preserve the social fabric.” Alternatively, a cultural value might be to consider other people as equals thus inducing individuals to recognize common interests as a basis of cooperation on a voluntary level. Social interaction then will be marked by low power distance. Schwartz calls this cultural value egalitarianism to express a generally accepted “...emphasis on transcendence of selfish interests in favour of voluntary commitment to promoting the welfare of others.” (Schwartz, 1995:97) The third question concerns the relation of humankind to the natural and social world. The contrasting pair of cultural values in this respect is “harmony-mastery” in the terminology of Schwartz whereas Hofstede quotes contrasting pairs of feminine versus masculine values complemented by high or low degrees of uncertainty avoidance which describes how societies value uncertainty. Harmony as well as feminist values coupled with a high degree of uncertainty avoidance describe an emphasis on fitting into the social and natural environment without any pronounced tendency to change it. Harmony hence expresses a conservative value dimension. By contrast mastery or masculine values emphasize the “...getting ahead through active self-assertion, through changing and mastering the natural and social environment.” (Schwartz, 1995:97/8)

The contrasting pairs of value dimensions do not exist in isolation but rather correlate with each other. For example, hierarchy and harmony (conservatism) relate positively to each other, since the acceptance of inherited roles mirrors a high value to keep the status quo. In the same vein we find a positive correlation between autonomy and egalitarianism because both build on the view that the individual should be valued as an autonomous being. (Schwartz, 1995: 98) Mastery which does not reject efforts to get ahead at the expense of others by contrast is positively related to both autonomy and hierarchy but negatively to egalitarianism.

Cultural values which characterize societies and thus their social preferences give rise to a particular system of social norms and thus also to a particular widely accepted governance structure. Licht et al. (2003), Licht (2004) show that for example the rule of law as a social norm which prescribes people to take the *law* as a guidance of behaviour instead of tradition, elderlies’ or superiors’ command, is consistent with societal emphasis on autonomy and egalitarianism, whereas this rule is less likely to be accepted in societies where embeddedness is valued high. They also found that in particular mastery does not show a close connection to the rule of law. Mastery legitimizes using other people if necessary in order to satisfy one’s own needs or those of the group. Corruption, defined as a common emphasis on use of power positions for private gains is found to be more likely to be accepted as a social norm in societies

marked by embeddedness, hierarchy and mastery than in societies where the autonomy of the individual together with egalitarianism are preferred. Finally, accountability will be accepted as principle of good governance in particular in societies with autonomy and egalitarianism as cultural orientations. The reason is that accountability claims from holders of power to give account of their decisions, i.e. make them transparent and legitimize them requiring that the powerful feel obliged to respect people subordinate in power. The authors emphasize that accountability which contains aspects of a representative democracy as well as civil liberties and voice will also have a high probability to rise as a social norm in societies high on egalitarianism but not in hierarchical societies. They also find mastery as incompatible with accountability since mastery legitimizes the pursuit of self-interest at the expense of others.

To summarize, principles of governance like the rule of law, accountability and absence of corruption which are accepted by governance researchers as pivotal for good governance are rooted in particular cultures, namely those emphasizing autonomy together with egalitarianism as prominent societal orientations. Investigations undertaken by Hofstede and Schwartz indeed make evident that in Western Europe and the US these values are more emphasized and accepted than in Asia and Eastern Europe, and indeed these cultures have developed a well-established democratic order and well-performing market economies resting on private ownership.

Research on the origins of cultural values as well as on factors determining their change is still in its infancy. Schwartz (1995) emphasizes historical events and religious orientations as well as accepted philosophical orientations and states that the greater emphasis of Western continental Europe on egalitarianism compared to the US roots in the motto of the French Revolution which combines “liberté” with “égalité” and “fraternité”. He furthermore holds that intellectual developments of the 17th and 18th century like the works of Hobbes and Locke provided the philosophical underpinnings for autonomy values. Furthermore he states that in “...the realm of religion, the Protestant Reformation and, subsequently, the secularization that affected Roman Catholic as well as Protestant nations, may also have contributed to the development of the view that the autonomous individual is the meaningful social entity...This was likely to promote Autonomy values at the expense of Hierarchy values.” (Schwartz, 1995: 112). He sees the rise of egalitarianism as a cultural value as closely related to the impact of Kant’s philosophy who stated that through reasoning the autonomous individual may commit itself to moral action, and Rousseau who stated that the autonomous individual is capable of compassion.

The Role of Private Ownership for the Performance of Banking Systems in Transition Economies

Implications of How Private Ownership Has Been Achieved

Starting from a socialist economy, manifold ways are possible to achieve a privately owned banking sector. This concerns the speed at which state-owned firms are privatized as well as the implementation of laws ensuring the enforcement of ownership rights. This also concerns the relative importance of newly created banks compared to privatized state banks. Further criteria are related to the difference between domestic and foreign ownership, the difference between dispersed and concentrated ownership, and also the issue of how state banks should be priced. Indeed, empirical investigations reveal that the choice of a particular privatization process had marked effects upon the results. Studies focusing on Central European countries have found a better performance of newly created banks compared to state banks both with respect to their profit as well as their risk situations. Notably this result is not only a consequence of inherited bad debts which exposed privatized firms with significantly worse initial conditions but also to their reluctance to change governance structures (Crotty et al., 2004). Also foreign-owned banks have been found to outperform domestic banks at least with respect to revenues. On the other hand it could not be confirmed that foreign-owned banks have enhanced the stability of the banking sector (Frydman et al., 1999; Mérö et al., 2003). A further issue concerns the structure of ownership. Transition countries share with Continental Europe a corporate governance structure marked by concentrated ownership (Berglöf and Thadden, 1999). Even in the Czech Republic which opted for voucher privatization initially dispersed ownership quickly turned into concentrated ownership through the creation of investment funds Crotty et al., 2004). Berglöf and Thadden (1999), emphasize that in evaluating the performance of closely held firms emphasis has to shift from boards of directors and shareholder meetings to cross-ownership and management networks.

In comparing the relative success of privatization in China and Eastern Europe, Miller et al. (2005) have found that a crucial explaining factor relates to the role of the state. They emphasize that privatization does not only involve a change in ownership but also a transformation in the role of the state. On the one hand the state had to give up power with respect to decisions on the allocation of scarce economic resources. On the other hand, however, strong state intervention was necessary to manage the process of transferring ownership and to implement the necessary legal order. In order to achieve these aims, the government must be willing and able to make credible commitments encompassing effective law

enforcement. In this respect the state does not act in a vacuum but has to be viewed as a part of the society which as has been emphasized for example by Raiser (1997) and Pistor (1999) has been guided by institutional legacy.

Institutional Legacy as A Major Impediment

The demise of communism did not leave the concerned societies with an institutional and cultural value vacuum. Formal as well as informal institutions including social norms were in place but the vast majority of them did not come up with the requirements of a market economy. The overall governance of the socialist society in general and economy in particular was marked by high centralization building on hierarchical principles. The result, however, was notorious scarcity of economic goods which gave rise to a system of informal institutions. Depending on the severity with which socialist principles were introduced, these institutions ranged from private firms which allowed to increasing overall production, and informal governance procedures in the state-owned firms attempting to circumvent regulation and thereby overcoming plan inefficiency and inconsistency (Crotty, et al., 2004) to those that merely redistributed produced goods. To these institutions belonged rules governing voluntary exchange in underground markets as well as corruption and bribery which at the time characterized widely accepted governing principles. Governance structures in the political as well as business sector were marked by a reliance on personal networks to achieve objectives, and low trust between rather closed network groups. These findings are closely related to the observation that the rule of law was never really accepted by the public. Following Tanchev (1998), the major reasons for the absence of the rule of law which she denotes as "legal nihilism" are to be found in the fact that communist constitutions never served to divide and thus limit power: The endeavours of the regime which was completely represented by the communist party, were directed to sustaining its power and an important tool in this respect was to decide legal questions politically.

Given the gigantic economic restructurings which are necessary in order to successfully turn a socialist country into a competitive market economy and given the low availability of internal financial funds during this process, it is without doubt true that the financial system plays an important role in channelling savings to promising investments without giving rise to rationing phenomena or conversely the accumulation of excessive risks thus plunging the economy into a financial crisis and hyper inflation. However, the same economic restructurings that are needed in favour of economic development pose challenges to providers and users of financial funds that previously have never been experienced by any country in this

world. Comparable historical examples have been missing, and hence providers of funds were exposed to radical uncertainty both with respect to the development of macroeconomic variables and markets as well as with respect to the capability and willingness of the users of funds to honour their contractual obligations. That (private bank) debt can act as a disciplinary device has been one of the messages of agency theory. However, in order to achieve this, bank managers have to follow principles of good governance themselves and beyond that the collection of debt has to be supported by appropriate laws and their effective enforcement which requires that sound banking governance principles are embedded in a system of overall governance promoting the honouring of contracts and providing external sanctioning mechanism to banks' mismanagement.

Increasingly scholars refer to institutional legacy as an impediment to economic transition (Raiser, 1997; Pistor, 1999). By this they mean in particular informal institutions, i.e. (injunctive) social norms and conventions. Our hypothesis is that in particular social norms stand out as informal institutions of significant endurance. The reason is that contrary to conventions which draw their wide acceptance from primarily cost-benefit advantages, social norms have been internalized shaping preferences. We show that in Hungary which already very early in history opted for Western cultural values, the institutional legacy was primarily marked by assumed conventions resulting from some pragmatic arrangement with the unavoidable Communist regime whereas in Bulgaria institutional legacy refers to a system of social norms grounding in cultural values which are hostile to a stable and efficient banking sector.

The Case of Bulgaria

Basic Cultural Value Dimensions

Bulgaria's history provided a rather unfavourable environment for the development of a civil society which shows a keen interest in socially benevolent patterns of interactions based on democratic rules. During five centuries, Bulgaria was under Turkish rule, and Orthodox Bulgarians saw no reason to comply with Islamic law (Tanchev, 1998) Rather disobedience to the law encompassing not only the civic society but also members of state and political institutions was considered as a national virtue. With Russian help the Ottoman era found an end by 1879 when a new constitution was put in place which by the standards of the time was characterized by highly liberal standards. Obviously, however, the liberal spirit of the constitution has never governed policymaking. Rather, as Tanchev (1998: 67) puts it "...actual power steadily gravitated to the royal head-of-state." Mitev (1998: 39) characterizes the era until the beginning of communism by two attitudes toward politics: "One looks on politics as a means of personal advancement and enrichment. The second takes the

form of an aloof, sceptical, alienated attitude toward politics." However, there appears to be a third attitude that characterizes a paternalistic tradition which led to the idealization of rescuers from all kinds of evils and leading to a cult of personality. (Mitev, 1998) During the Communist era Bulgaria developed into a totalitarian system marked by successful attempts of the Bulgarian Communist Party (BCP) to use the judiciary in order to strengthen its political power.

Between 2000 and 2002 a sociological survey with the title "Organizational Culture in Bulgaria – 2000-2002", followed the methodology of Geert Hofstede with the aim to calculate indices of power distance, uncertainty avoidance, individualism – collectivism, masculinity – femininity (harmony versus mastery in the terminology of Schwartz). (Davidkov, 2004). The study confirms that still in 2002 Bulgaria fell among countries with pronounced power distance. The study also discovers indicators of strong uncertainty avoidance. In accordance with uncertainty aversion it was found that Bulgarians are rather reluctant to accept novel ideas and innovations. Furthermore heterogeneity is perceived as a major threat and not as a resource that can be taken advantage of. On the other hand Davidkov (2004) remarks that Bulgaria does not show traits which are also typical of countries with high uncertainty avoidance, namely a high respect of the law. In contrast he finds that the law in Bulgaria is not highly respected. This indicates that values do not appear in isolation. A low or missing respect of the law might be connected to high power distance (hierarchy) coupled with collectiveness. Indeed, the study confirms that Bulgaria is better described by a low level of individualism (autonomy) and correspondingly high level of collectivism (embeddedness) implying that typically Bulgarians define their identity by the social network to which they belong and that trespassing this network leads to shame and loss. In accordance with this it was found that in most of the investigated cases personal opinion is not encouraged. Finally the study finds Bulgaria to value traits high that correspond to feminine values (harmony in the terminology of Schwartz). For example, in general both men and women are expected to be timid and not assertive. The prevailing norm for schools has been found to be the average student. Managers are more often concerned with solidarity among workers and not with competition between them. "The evaluation comment "he is a good person" prevails over the evaluation comment "he is a true professional". (Davidkov, 2004: 27) However, the study also makes evident that these values are more pronounced among the elderly, among less educated groups and among inhabitants of smaller towns and villages (Davidkov, 2004).

Implications for the Development of Bulgaria's Banking Sector until 1997

This found cultural profile can be said to have had an impact on the process of political and economic

transition to be observed in Bulgaria in general and the development of the banking sector in particular leading the country into a disastrous crisis by the middle of the 1990s (National Development Report, 1998). It is true that Bulgaria faced even harder initial conditions than countries like Hungary or Poland a major reason being its higher dependence on USSR markets and a more pronounced interference of the socialist government into practically all spheres of life which did not allow to developing even fragments of a private sector (Berlemann et al., 2002). Bulgaria's role as a showpiece of Soviet communism might have contributed to the observation that "...the disenchantment with the communist regime in Bulgaria had not reached its peak." Mihov (1999: 4)) This finding might offer a plausible explanation for the fact that the former socialist elite who had profited most from the system basically remained in political and economic power thus determining not only the development of a new institutional order but also the rules of governance in the political and judicial sphere as well as in the business sector. These rules were marked by corporatist patterns between all parties fostering personal enrichment. It is true, that the first private banks were already licensed in 1991 and grew in numbers during the following years. It is also true, however, that with the exception of the First Private Banks they all remained small and did little to promote real development (Enoch et al., 200). In particular a private banking sector which acted a promoter of economic transition was largely absent. A crucial role in this process was played by financial elites which entertained close relationships with the Bulgarian Socialist Party from which they received the money and the official permission to start banks. Once rich they were able to get access to political and administrative circles thus receiving the funds to refinance their unsound banks (Daskalov, 1998). The newly created private banking sector was often used to finance dubious privatization deals executed by managers of state-owned firms (Berlemann et al., 2002). By 1996 none of the banks had been privatized and it were the state banks that dominated the banking industry holding two thirds of bank assets (Enoch et al., 2002:8). Notably the shares of these banks were not only held by the government but also by state-owned firms who were borrowers themselves (Enoch et al., 2002). In due consequence, the government used state-owned banks to extend loans to state enterprises thus subsidizing their losses (Berlemann, 2002; Mihov, 1999). Insider lending was widespread and internal credit controls were largely missing. The low quality of loans extended to state-owned companies is closely related with a governance structure frequently referred to as "crony capitalism" that gave priority to asset stripping over restructurings in favour of long-run profitability (Peev, 2002). State enterprises were marked by "corporatization" which means the state held 100% of the firm's shares. These firms were largely controlled by their managers and other interest groups who both did not appear much

interested in increasing the firm's profitability but rather maximized their short-run utilities. As Peev (2002) describes it:

"During 1992-86, the system of "crony" capitalism emerged with its main network being among former communist nomenklatura circles, weak state institutions and the criminal world. The typical motivation of the agents in this sybiosis has been to ransack national wealth." (84)

The principles of "crony capitalism" were also transplanted to private businesses which were created by managers of state enterprises in order to profit from transfer pricing. Notably these transactions were funded by the banking sector, too (Peev, 2002). A prominent feature of these "crony capitalism firms" was their reluctance to repay their debts. In state firms this attitude was supported by the ongoing readiness of the government to provide new debt, in the private sector an inclination of bank managers to flee the country might also have played a role. In sum we may state that the Bulgarian banking sector quickly developed into a rather fatal version of relationship banking embracing the corporate sector, the government sector and bank managers in a coalition that used the banking sector as a tool to rob households of their savings thus being marked by poor governance (Daskalov, 1998; Berlemann et al., 2002).

The then prevailing governance structure in the business sector which was running counter to principles like the rule of law, accountability/transparency and absence of graft was complemented by governance failures in the political and judicial sectors which basically were under heavy influence of the same groups that dominated the banking industry. In this respect the Law of the Budget which subordinated the independence of the central bank to fiscal needs features high (Berlemann, 2002; Mihov, 1999). Schönfelder (2005) emphasizes that Soviet-type procedural law remained in action until 1997 which restricted the seizure of essential assets of socialized companies and provided for liberal exemptions for all sorts of debtors. A final example for false regulation is given by the Bulgarian deposit insurance scheme which was implemented by 1995 and factually was a state guarantee to 100% of deposits. This regulation enforced moral hazard in the banking industry further. The legal order was not only characterized by "false regulations" but also by missing regulations. In 1992 the Law on Banks and Credit Activity was adopted which established the regulatory framework for the activities of banking institutions. It regulated licensing and enacted a minimum capital requirement of 4%. Furthermore banks were required to collateralize debt. It left open, however, the issue how failing banks should be handled and in particular it did not contain the legal option to close insolvent banks. Moreover the absence of a bankruptcy code until the middle of the 1990s prevented the central bank from closing failing banks.

Besides false and missing regulations poor law enforcement of appropriate laws was significant. One example is provided by severe restrictions that had been imposed to the central bank's supervisory powers. In fact the Bulgarian central bank (BNB) was not allowed to place conservators in failing banks (Enoch et al, 2002: 12). Another example concerns the courts which proved rather unwilling to punish fraudulent behaviour as a cause of loan default (Enoch et al, 2002: 22). Schönfelder (2005) adds that the judges were highly dependent on the government. He describes that "...at least under the socialist Videnov government ruling in 1995-1997 a judge who ignored the exemptions went against the explicit will of government...Videnov's minister of economics... expressly proposed that state-owned companies should not service their debt to state-owned banks, arguing that state companies should engage in mutual support." (179)

This development was tacitly tolerated by a rather mute community of depositors. In accordance with inherited paternalistic thinking they believed in the functioning of a public insurance system even before it was formally introduced. With inflation rising to exorbitant levels, with an increasing number of state banks being prone to fail, by 1995 the public finally became aware of the severity of the situation and reacted with bank runs which triggered contagion effects pushing the banking sector into a crisis. Initial policy response was marked by half-hearted measures. In particular the BNB failed to apply to the court system with the intention to close insolvent banks. The banking system relapsed into crisis which was now accompanied by severe depreciations of the Bulgarian currency as a due consequence of currency substitution. The banking crisis spilled over to public debt markets and the payments system (Enoch et al, 2002). The real economy plunged into a deep depression.

Lessons from the Crisis: Bulgaria relies on Outside Control Mechanisms

Bulgaria's way into the banking crisis was marked by a governance structure with insider control mechanisms dominating. Insider-controlled systems are not a priori detrimental to aggregate welfare as the German example shows, a necessary condition being that the actors in power take aggregate consequences of their actions into account thus giving priority to efficiency and not redistribution (Cable, 1985)

However, this necessary condition obviously was not met in Bulgaria where networking served to maximize personal interests at the cost of others. State ownership proves particularly detrimental in such environment since political and economic powers coalesce and leave no chance to taking minority interests into account. However, private ownership, too, is unable to promote transition. In particular the former socialist elite formed a powerful group controlling the political, judicial and business sector,

and in doing so, they controlled themselves. With respect to the bank credit market for example, this implied that the knowledge of individual personalities served as a substitute for objective data, and that for example lending to friends and members of the own network who never repaid, was popular (Koford et al., 1997). On the other hand, borrowers who did not participate in the same networks like their bank were rather reluctant to repay their debt which also meant that collateralized assets would disappear all of a sudden (Koford et al., 1997). If a bank sought litigation it soon found itself treated unfair by the courts which had frequently been influenced by their borrowers (Koford et al., 1997). Indeed, following Schönfelder (2005) litigation was not common among banks and he adds that banks rather preferred illicit Mafia methods to get their money back.

In such a setting, a basic message of agency theory gains importance namely that *outside* control has disciplinary effects on opportunistic agents. Of course, outside control in this country promised to be successful only if outside meant "foreign" and if in this respect not only the private sector was concerned but the public sector, too. Indeed Bulgaria has chosen this way – at the time supported by a large majority of voters who had triggered off a political change in favour of a government which appeared more determined and capable to establish necessary reforms. The introduction of the *currency board* was not only a first but also a major step taking into account that its functioning does not only imply a factual independence of the central banks. The sustainability of the currency board depends on the credibility of the official exchange rate. In particular the accumulation of bad debts in the banking sector which gives rise to speculative attacks on the domestic currency can impair this credibility. In due consequence, the currency board was coupled with a new "Law on Banks". This new law introduced measures of prudential regulation which even exceed international and EU standards. This is in particular true with respect to the capital requirement ratio which amounts to 12% as compared to the EU provision of 8%. Required reserve ratios were initially fixed at 11% and later reduced to 8%. The new law also expands the supervisory authority of the BNB making it easier for the central bank to close failing banks. Moreover banks which now have to undertake internal risk control based on rating procedures according to the Basel Accord, are now regularly controlled by experts of the Banking Department the result of which is reported in a Quarterly Bulletin issued by the BNB.

As a further measure of capital controls were lifted thus facilitating FDIs as a potential further external control mechanism. These measures were coupled with a massive privatization programme, and by 2000 more than 73% of banking system assets were in foreign ownership (Miller et al., 2002). The share of foreign banks increased even further and in 2003

reached 86 per cent of assets in the banking system (Tschoegl, 2003).

However, the implementation of external control mechanisms appears to be a necessary condition only for the avoidance of credit crunches or hazardous over-lending, respectively. Though the currency board together with a deposit insurance system increased households' trust in the banking sector and also made foreign denominated deposits available to banks, the years until 2001 were marked by a pronounced reluctance of the commercial banking sector to extend loans to the Bulgarian private sector, in particular to firms. Rather, banks preferred investing abroad (Miller et al, 2002; Nenovsky et al, 2003). Credit shrank dramatically shortly after the crisis had reached its peak, declined even more after the introduction of the currency board and remained at below 20% of GDP until 2001. (Nenovsky et al, 2003) In an empiricaleconometric analysis Nenovsky et al (2003) searched to explain this phenomenon. They did so testing hypotheses related to credit demand and supply based on data comprising the period between 1998 and 2001. Their major findings are the following: The currency board obviously did not curtail the lending capacity of the banking sector, implying that foreign reserves did not impose an upper constraint to lending. Rather, banks' reluctance to lend to the corporate sector can be explained by conservatism supported by the new system of prudential regulation and supervision. However, the authors have also found evidence that in this period bank lending was not much related to the financial health of enterprises. For example, no negative correlation between borrowers' leverage and the size of loans was found. There is moreover evidence that larger firms and firms with the presence of majority owners had better access to bank loans. The same result was found for firms which are affiliated to business groups and have political connections, and firms with an offshore owner with rather dubious origin of capital. The authors conclude that the findings are related to prevailing governance structures which were still marked by crony capitalism. Indeed privatization in the corporate sector which took place above all between 1998 and 1999 (the so-called mass privatization), predominantly rested on voucher privatization and management and employee buyouts which according to Peev (2002) promoted the rise of new crony firms. Peev has found evidence for a dual enterprise sector with two types of governance structures, i.e. one resembling Western principles and crony capitalism. Notably crony firms were also to be found among enterprises under foreign ownership, and newly created firms, too. Obviously these crony firms enjoyed more favourable lending conditions between 1998 and 2001. Miller et al (2002) have moreover found evidence that in the first years after the introduction of the currency board court procedures were still slow and inefficient throwing up many barriers to lenders.

The years following 2001 have been marked by the gradual increase in bank lending to the private sector one reason for this being the gradual reduction of foreign rates of return due to the weak condition of the world economy as compared to the ongoing economic recovery in Bulgaria (BNB Economic Review, February 2005). To what extent governance practices in both banks and non-financial enterprises have changed and which role the legal order might have played in this process, remains unclear, however. With respect to the development of further credit-market friendly institutions, the bankruptcy code has been the primary subject of Schönfelder (2005). He observes that despite several amendments in the years 2000 and 2003, legal means to collect bank loans are still exposed to constraints. Upon these constraints he mentions that for example after "the trial court has decided...the creditor still needs to institute proceedings at the enforcement court. Only the fisc, some public utilities and holders of special liens are exempted from this requirement." (185) He continues to note that even if the execution court has started to work, the debtor may delay the further proceedings by various objections. In 1997 it became punishable under criminal law if an insolvent firm did not file for bankruptcy. However, according to Schönfelder (2005) among borrowers this law has not yet been perceived as a serious threat.

As regards bank governance some results of BNB supervision between January and March 2004 may be conclusive (BNB Quarterly Bulletin, March 2004). Here the BNB deplors as a new development the lack of adequate and rational reactions by banks to potential hazards involved by credit expansion. Bank managers proved to be over-optimistic as regards their borrowers' investment strategies. The supervisors found increasing "risk appetites" of bank managers. Some banks made loans to firms with unclear liquidity conditions. The central bank found that credit risk increases due to serious weaknesses in lending process management and significant lending to related interest. Banks with already low ratings increased credit risk further. Banks were reducing their degree of gross asset provisioning. Finally the BNB supervisors detected banks that did not any more meet capital requirements. Overall the capital adequacy indicator revealed a downward trend. Of course this evidence might also be explained with bank managers' lacking experience. However, taking the large degree of foreign ownership into account, one should not jump to conclusions. It may well be expected that foreign owners have an eye on their managers' skills and promote training programmes. Hence a significant role for the Bulgarian cultural legacy might still exist.

The Case of Hungary

Basic Cultural Value Dimensions

Contrary to Bulgaria and other countries of South-East-Europe, Hungary opted very early in her history

for the value system shaped by Roman catholic Christendom.¹⁶ From the 11th century Hungary's eastern and southern borders marked the borders of the Western world. Notably the influence of Italian Renaissance had reached Hungary earlier than any other country in central Europe.¹⁷ Like Bulgaria, Hungary was threatened by the approaching Ottoman Turks. Contrary to Bulgaria it called for the help of the then rising Habsburg Empire. Even though Habsburg did not really provide sufficient support to prevent the Turks from occupying at least one third of Hungary, this decision marked another milestone with respect to Hungary's value orientation. Indeed, Hungarian guardsmen at the Viennese Court became familiar with the French and German Enlightenment and influenced greatly the Hungarian literature. It appears that in particular a literary elite survived the political upheavals in the aftermath of the French Revolution. This cultural value orientation that put democratic principles, freedom but also social responsibility and political independence into the centre provided the background of a resistance against the Habsburg Empire which culminated in the March revolution of 1848, but also in the October Revolution of 1956 and it paved the way of Hungary into democracy in the 1980s. Hungary's history fosters Hofstede's finding that this country does not deviate much from the average of West European countries as regards power distance and individualism.¹⁸

In particular the upheaval of 1956 had a sustainable impact on the Communist government led by Kádár who remained in power until the demise of Communism. In order to keep the population "quiet", Kádár's attempts were directed at providing households with a high standard of consumption. In order to achieve this, increasingly market mechanisms were tolerated, starting with the New Economic Mechanism in 1968 and culminating in the 1980s with a significant opening of the Hungarian economy and the introduction of a two-tier banking system (Habuda, 1995). Foreign trade was characterized by close economic ties with Western Europe and the implementation of joint ventures with foreign companies like General Electric, Siemens, and Shell. Increasingly Hungarian employees were involved in a growing market economy which became an important driving force of Hungarian well-being. Judging from this evidence, Hungary started transition with significantly better initial conditions than Bulgaria since Hungarians could resort to a long standing democratic tradition as well as to some experience with market mechanisms, and economic relations to OECD countries.

¹⁶ Already in the 10th century Hungary converted to Roman Catholic Christendom.

¹⁷ Fact Sheets on Hungary. Ministry of Foreign Affairs, Budapest 2000

¹⁸ Hofstede replicated his 1980 studies several times. This result dates from 2002 published as electronic source www.geert-hofstede.com/hofstede-hungary.shtml.

However, the Kádár regime gave rise to its own system of informal institutions that hampered the process of economic transition in general and a well-functioning banking sector in particular until the middle of the 1990s. The attempt to provide the Hungarian population with a high standard of consumption produced a paternalistic system with the incumbent management of the large state-owned firms gaining more and more economic as well as political powers. In this paternalistic system workers were granted regular wage increases and improvements in social securities whereas trade unions were weakened and did not play a significant role. On the one hand managers assumed the task to deliver consumption goods which at the time were termed "political goods" (Bruszt, 1995) since they were considered as important in favour of political stability. On the other hand, incumbent managers were treated as responsible for economic rationality (Bruszt, 1995) which provided them with a high degree of economic independence. In order to provide these political goods, managers bargained successfully for more resources and they too gained control over strategic political decisions by being co-opted into the higher decision-making bodies of the state (Bruszt, 1995). Rising power of the incumbent management was paralleled by dwindling powers of in particular the branch ministries.

Hence the political and economic governance of the country was crucially influenced by the managers of state-owned enterprises whereas the workforce either saw its major playing field in the private sector if this proved successful or coalesced with managers if they found that entrepreneurship would bring them no extra income (Bruszt, 1995) Indeed the Kádár era is also marked by an ongoing struggle of state offices and managers against each other. This struggle was continuing after the beginning of the transition process and affected in particular privatization which turned out to be a highly opaque process lacking a solid legal foundation approved of by the Parliament.

The Kádár Legacy Determines the First Attempts of Privatization

In the literature we find Hungary's privatization process classified into three stages: spontaneous, centralized and decentralized privatization (Bruszt, 1995). The management retained its power at the beginning of the transition process. Active managers of large firms became members of political bodies and they started a process of so-called "spontaneous privatization" which in fact meant that managers became the legal owners of public enterprises (Bruszt, 1995) However, this process did not go uncriticized. In particular the state bureaucracy saw its chance to regain control. In the spring of 1990, the Hungarian Democratic Forum came into power and sought to strengthen the role of state bureaucracy insulated from outside political pressure at the same time intending to weaken the role of managers. A process of

“centralized privatization” was initiated which meant that a newly created agency (State Privatization Agency, SPA) received the right to re-nationalize any public enterprise if this served to protect state assets and its sale. Later on the State Property Company (SPC) was founded with the task to control enterprises which were not intended to become private (Bruszt, 1995). A major consequence of centralized privatization was the re-nationalization of large firms thus turning the firms again towards the state. This was also mirrored by a strengthened control of the governing party over the SPA. Its privatization strategy aimed at avoiding splitting up or restructuring firms. In due consequence mainly foreign investors could finance the purchase. It is true that the sales price was fixed in a competitive bidding. However, it is also true that increasingly investors had to commit themselves to fulfil other criteria like maintaining employment. Indeed the success of this privatization programme turned out to be rather modest (Voszka, 1995). The Financial Ministry, deploring insufficient revenues from privatization together with branch ministries concluded an alliance against the SPA and initiated a third round which later on was termed “decentralized privatization.” (Voszka, 1995) because now the ownership was transferred without direct interference of the SPA, but with the support of consulting firms. In fact the decentralization strategy was accompanied by re-nationalization which meant that a growing part of SOEs were transformed into companies without majority private ownership (Voszka, 1995).

This development was accompanied by a significant decrease of production and increase in employment promoting a political change in 1994 when the Hungarian Socialist Party gained an absolute majority in Parliament. This government attempted to speed up the process of transition by selecting increasingly strategic foreign investors allowing them to gain majority shareholdings. In this way Hungary, too, resorted to external control mechanisms. This course was continued beyond the 1998 elections when again the first post-Communist government regained political power transferring the bulk of the country’s industrial and trading enterprises, as well as financial institutions, from state to private ownership.

Implications for the Hungarian Banking Sector

The Hungarian banking sector can be said to mirror the described developments in the Hungarian society and business sector in general. Already in the 1970s the first foreign participations in the Hungarian banking sector took place, a development which is closely associated with Hungary’s opening to foreign trade at that time (Majnoni et al., 2003). Already prior to the establishment of a two-tier banking system, foreign ownership was present with three joint venture commercial banks having reaching a market

share of 5% (Szapáry, 2001) Furthermore due to Hungary’s opening to trade some international orientation of the National Bank of Hungary and the Hungarian Foreign Trade Bank could be observed already in the 1970s. When IMF membership was acquired, these relations were further enhanced (Várhegyi, 1996). Irrespective of political criteria which predominated in particular the selection of top managers, in the banking sector it even proved to be harder than in the real sector to ignore professional aptitudes. This was a due consequence of international credit transactions which produced some control mechanisms exercised by foreign creditors (Várhegyi, 1996). Throughout the 1970s and 1980s the credit personnel of the Hungarian National Bank increasingly acquired skills which are characteristic of lending practices in market economies. Hence it was not a lack of skills that prevented the incumbent management from prudent lending but both the consequence of political pressure and missing sanctions in case of defaulting loans. As Várhegyi (1996) puts it: “If it became obvious that an earlier allocation of credit was a mistake, the creditors of the bank and the financial managers of the company lacking the credit supported each other, proving that poor performance was attributable to the deterioration of external conditions” (2). Practically this meant that the problem of bad debts could not be avoided.

Taking Hungary’s international orientation into account, it is not surprising that Hungary was the first CEEC country to start a fundamental reform of its banking system. The process started with turning the mono-bank system into a two-tier-system which left the newly founded three commercial banks in state ownership. Furthermore a liberal entry policy was decided with licenses being granted rather automatically. This led to a growing number of Greenfield banks until 1994.

The process of establishing a banking sector marked by private ownership in Hungary is closely related to foreign ownership. Empirical findings reveal that basically three motives drive foreign investors (Mérö et al., 2003): to serve their domestic clients abroad (defensive expansion hypothesis), to exploit host country opportunities, and to avoid regulations at home. The liberal licensing policy in Hungary together with its tradition to allow foreign trade thus establishing firm relations to foreign firms, have attracted foreign investors in the banking sector already in the 1980s. Foreign owners came primarily from EU member states with banks of neighbouring countries (in particular Austria) having a prominent share (Mérö et al., 2003). For the first years of the 1990s Greenfield investment in the banking sector was characteristic, and there are some signs that foreign investment in the banking industry was led by the defensive expansion hypothesis (Mérö et al., 2003; Majnoni et al., 2003). On the other hand, Austrian banks have been attracted by growth opportunities from the very beginning which can be explained by their past historical and cultural relations

thus providing them with a well-founded knowledge of the Hungarian economy and society (Majnoni et al., 10). The main motive of the Hungarian government to attract foreign banks was to stabilize the banking sector by increasing banks' capital. By the end of 1994 eight wholly foreign owned Greenfield banks accounted for 10 percent of the capital in the Hungarian banking sector (Majnoni et al., 2003). Privatization of state banks did not play an important role until 1994. It is true that already in 1989 some West European banks sought to acquire participations in the two largest commercial banks which was welcomed as a chance to increase banks' capital.¹⁹ It is also true that partial privatization of banks of lower importance took place in the early 1990s. Taking into account the newly created banks, by the end of 1990 the share of the state in the banking sector had fallen to 39%. However, private participation in state banks was not allowed to exceed 10%, and beyond that, in the course of the consolidation programmes, the state regained direct influence ending up with 86 percent as a proportion of equity capital (Majnoni et al., 2004).

Hungary, too, had to suffer a banking crisis, though with significantly less harmful effects than in Bulgaria. Apart from the sharp drop in aggregate output in the initial years of reform, two further reasons stand out in this respect: First, the state banks which were created in 1987 encountered rather unfavourable initial conditions not only due to inherited bad debts as such but also because the portfolios taken over from the NBH were marked by sectoral segmentation enhancing the accumulation of bad risks even further (Szapáry, 2001). A second reason is rooted in the regulatory framework which until the end of 1991 did not oblige banks to practice prudent lending, and which at the end of 1991 resorted to a legislative shock therapy. For example the Financial Institutions Act imposed stricter rules for loan classification based at least partly on BIS standards, making loan-loss provisioning compulsory. The Accounting Act forbade to treat interest rate receipts as income in the books. A Bankruptcy Law required firms to initiate self-bankruptcy procedures in case of default for more than 90 days. In 1992 Bank supervision was transferred to an autonomous agency (Szapáry, 2001). Whereas the shortcomings of the regulatory frameworks encouraged banks to mask their true problems and encouraged them to continue "evergreening", the obligation to make loan-loss provisions and implied by this the obligation to increase transparency regarding credit risks together with a strict enforcement of the Bankruptcy Codes (Szapáry, 2001), contributed significantly to the fact that by 1992 some of the state-owned banks had lost their entire capital.

¹⁹ The state sold 20% of the Inter-Európa Bank to San Paolo di Torino, 50% of ÁEB to US financial investors, and 20% of the Postabank to three Austrian financial institutions (Majnoni, et al., 2004)

In this situation the government decided to launch a consolidation programme in late 1992. The programme proceeded in three stages thus responding to the fact that the true magnitude of the problems was recognized only gradually. The first stage was marked by portfolio cleaning. Basically this meant that banks and savings cooperatives having a capital asset ratio below 7% were allowed to transfer part of their bad debts in exchange for government bonds. Banks tried to sell remaining bad loans to special work-out companies. This first stage of consolidation was not successful because the really doubtful loans were never exchanged against government bonds but remained on the books and furthermore the measures taken were not tied to changes in the management of banks (Szapáry, 2001). This gave rise to the second stage at the end of 1993, focusing primarily on enterprise-oriented portfolio cleaning. Following Szapáry (2001) these measures saved some of the large debtor firms which were reorganized and successfully privatized later on. However, stage two consolidation also did not stop the increase of non-performing loans which reached close 30% of total bank portfolio in 1993 (Szapáry, 2001). In this respect the tighter regulatory framework plays an important role (Szapáry, 2001), but also inherited corporate governance practices. Corporate governance in the banks with significant state ownership was characterized by the fact that top managers continued to be nominated by the government which according to Várhegyi (1996) "...renewed the formerly well known bargaining processes between the bank managers and the government" (9). She remarks that during the consolidation of credit, managers tried to mask the existence of bad credit whereas later on when privatization was on the political agenda, they overestimated losses. An example of close relations to the Ministry of Finance is provided by the way how the incumbent management reacted to the Act on Financial Institutions which obliged banks to build provisions for bad loans. In fact the Ministry of Finance encouraged state banks not to do so but rather pay taxes, and state banks indeed welcomed this idea. Recapitalization characterizes the third stage of bank consolidation. Banks were allowed to issue shares which were purchased by the government (Szapáry, 2001). Recapitalized banks were required to set up a consolidation programme including measures to improve internal controls. Total cost of consolidation in Hungary were only slightly less (13%) than in Bulgaria (14%) the reason for this being that the level of bank intermediation in both countries have been rather low measured by international standards. Still in 1999, the percentage of loans to the private sector of GDP was only 25% compared to more than 100% in Germany and Japan (Szapáry, 2001).

Like in Bulgaria, the banking crisis or better to say its negative consequences for the economy might have contributed significantly to the change in government in 1994. But whereas in Bulgaria a Communist government was dismissed, and a

democratic party came into power which initiated necessary reforms, in Hungary the Socialist party won the elections over the democratic party, and it was the Socialist party which now followed a decisive market-friendly course. This course was characterized by the privatization of yet state-owned firms with state banks posing no exception. In this respect foreign strategic investors were supposed to play a crucial role. Strategic investors regularly have a keen interest in a company's business which requires them to achieve a majority shareholding, and indeed by the end of 1995 six state banks which together represented a market share of 31%, were sold to foreign banks (Szapáry, 2001). The contribution of foreign capital to the Hungarian banking sector increased continuously in the years to follow and reached 78% of the banking sector's registered capital in 2002, whereas state ownership has dropped to 19% and is restricted to banks with specific public functions (Mérő et al., 2003). A further trait of the "new conception" was the attempt to comply with the requirements for EU accession. To achieve this, in 1997 the Credit Institutions Act was enacted which harmonized prudential supervision with EU and BIS standards. In 1998 and 1999 further regulations to harmonize other banking practices with EU requirements were introduced. The evaluation of the effects of private ownership on the performance of the Hungarian banking system is closely related to the assessment of how foreign ownership in the form of strategic investments affected stability and the banking sector's contribution to growth. Evidence so far suggests that foreign investors have contributed to creating a stable and well functioning banking sector (Ábel et al., 2001). In this respect Ábel et al. (2001) found a continuous increase in the portfolio quality of Hungarian Banks as a whole between 1987 and 1997 as well as a continuous increase in the capital adequacy ratio. Whether banks contribute to economic growth is also dependent on the degree of concentration. A high concentration in the banking sector indicates market power which can be abused to claim excessive interest rates and collateral. Foreign banks contributed significantly to enhancing competition which is mirrored in a continuous decline of concentration in the banking sector between 1989 and 1999. (Ábel et al., 2001). Szapáry (2001) found that the degree of concentration is lower in the market for corporate loans than in the market for consumer loans due to a higher number of banks operating in the former. Profitability is also used to indicate a banking sector's stability. Measuring profitability by cost efficiency (measured by operating and labour costs) and profit efficiency (measured by the return on assets), Majnoni et al. (2003) have found Greenfield banks with performing better both with respect to cost and return irrespective of whether they are domestically or foreign owned. In particular only Greenfield banks were able to reduce interest rate margins. The authors also observe that management styles have been more important with respect to cost

efficiency. In particular local management has supported the reduction of operating costs. In fact the Hungarian company law prescribes that at least two directors of a bank shall be Hungarian citizens. In particular Austrian, German and Italian banks entrusted local managers with the management of their banks more than others. Total assets of credit institutions as a percentage of GDP have increased since 1997. The share of loans to the corporate and household sectors in the total assets of banks which remained between 33% and 34% between 1995 and 1998, rose to almost 42% in 2000, whereas the share of non-performing loans in the total loan portfolio of banks continued to decline (Szapáry, 2001)

Judging from Hungary's cultural legacy it appears astonishing that Hungary, too, resorted to external mechanisms in order to improve the performance of its banking sector. On the other hand it should not be overlooked that the Communist regime, too has left its traces. A combination of practical and political reasons might explain why foreign strategic investors were highly welcome. Practical reasons are closely related to the fact that the Hungarian banking sector by the middle of the 1990s suffered from a massive lack of capital. Foreign ownership in this situation offered a solution which, different from money creation, was neutral with respect to inflation. The decision in favour of foreign ownership was certainly facilitated by Hungary's long-standing relationships to the Western business world. However, political reasons might also have played a role. Political dependency greatly contributed to mismanagement in state banks irrespective of managers' skills, and contributed to violating the regulatory framework. And indeed, the Open Society Institute 2002 does not mention the banking sector as a prominent place of corruption in its report on corruption and anti-corruption policy in Hungary. Taking into account that countries like Austria, Germany and Italy who pertain to the group of the largest strategic investors rely heavily on local managers, this indicates that foreign ownership has fostered the separation between banks management and politics. On the other hand, it should be recognized that the relative success of the Hungarian banking sector will be sustainable only if principles of good governance also characterize banks' corporate borrowers as well as the public sector. In this respect Hungary has revealed significantly less reluctance than Bulgaria with respect to the implementation of appropriate laws. Also law enforcement has proven to be superior to what has been found in Bulgaria. For example Hungary has been perceived as one of the least corrupt post-communist state (Open Society Institute 2002). This confirms a higher validity of the rule of law as a social norm.

Conclusions

Economic transition has proven to be above all a process of transforming socialist institutions into

institutions which are conformable to a successful market economy. In this process the establishment of private ownership played a crucial role. We have shown that the merits of private ownership depend on whether principles of good governance like the rule of law, accountability together with transparency as well as the absence of graft are widely accepted as guiding rules of behaviour not only within corporations but in the political and judicial sphere as well. We have also shown that the extent to which this occurs, is not primarily a matter of law but of the extent to which principles of good governance are widely accepted as social norms. According to cross-cultural psychology this depends on the acceptance of more fundamental social norms which constitute basic cultural value orientations. A society which values individual autonomy together with treating others as equals high, will be more prone to complying with the rule of law, with accountancy and transparency, and this society will be more reluctant to resort to fraudulent practices or corruption as means of coordination. Values like this are characteristic traits of mature market economies – or differently put – the well-functioning of a mature market economy can be explained as the final outcome of these value orientations. By contrast in societies where the individual draws its value from the value of the group he is embedded in, and where steep hierarchies are accepted as something natural, the rule of law will only play a minor role as compared to the role of tradition and the advice of superiors. Moreover the predominance of strong ties with group members facilitates closedness undermining transparency and accountability with respect to outsiders. The acceptance of hierarchies in its turn has been found to undermine the role of exchange at eye level in favour of graft. We have found some evidence that Bulgaria and Hungary expose differences regarding their basic value orientations which contributes to explaining differences as regards the performance of either banking system in relation to the role of private ownership. In Bulgaria where embeddedness and hierarchy has been found as basic value orientations, principles of bad governance like corruption, absence of the rule of law and missing accountability did not only hamper the privatization process. Of equal importance is the fact that private banks were frequently founded to maximize the personal interests of their owners depriving depositors from their savings. As a way out, Bulgaria opted for the introduction of a currency board thus resorting to external control mechanisms. This allowed the banking system to recover. However, there are still signs that crony capitalism undermining prudent and efficient lending plays a role. As compared to Bulgaria, throughout its history, Hungary has been more oriented towards Western value systems. This even affected the Kádár regime which did neither oppress entrepreneurship nor the evolution of markets and moreover fostered trade with OECD countries and even allowed joint ventures with Western banks.

Of course, market elements did not dominate politicization but it appears that the rules characterizing Hungarian paternalism of the Kádár regime had been accepted by people as conventions rather than as entrenched social norms. Hungary fostered the creation of private banks from the very beginning. However, like Bulgaria, Hungary proved rather reluctant to privatizing state owned banks. Like in Bulgaria this happened in Hungary only after alternative solutions to overcoming the banking crisis were not available. Both countries, however, differ with respect to how privatization was accomplished. In Hungary foreign strategic owners were successfully attracted who also invested in newly created banks. Notably, foreign ownership did not mean the exclusion of Hungarian managers from top levels. Rather, following empirical investigations, the best performing foreign banks rely heavily on local managers and directors. Our work has left open the question, how changes in value orientations can be achieved. In this respect further research exploring the role of education, but also the guiding role EU accession and membership appears promising.

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ARE CORPORATE GOVERNANCE SYSTEMS TYPOLOGIES RELEVANT? EVIDENCE FROM EUROPEAN TRANSFERS OF OWNERSHIP RIGHTS

Rafik Abdesselam*, Sylvie Cieply*, Anne-Laure Le Nadant*

Abstract

Corporate governance systems vary considerably across Europe, reflecting the differences in the financial and legal systems, and in corporate ownership structures. The purpose of this paper is to identify the relevant governance system typologies. To test the robustness of the typologies, we study transfers of ownership rights that may be an important determinant of corporate governance in the largest European economies. Results overall invalidate the expectations induced from the theoretical analysis of national corporate governance systems. They suggest that the classical typologies are insufficient to distinguish between governance systems as they miss to capture institutional complementarities and political differences. Our unexpected results could also suggest a convergence of the systems, not towards the Anglo-American model, but towards a new model.

Keywords: Corporate governance, market-based economy, bank-centred economy, investor protection, ownership structure, mergers and acquisitions, leveraged buyouts, initial public offerings, transfers of minority stakes, private equity.

* Address for correspondence: Anne-Laure Le Nadant, UFR de Sciences Economiques et de Gestion, 14032 Caen Cedex, France.
Email: anne-laure.lenadant@unicaen.fr

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1. Introduction

Despite globalisation and European integration, corporate governance systems still vary considerably across Europe, reflecting international differences in financial systems, legal regimes and corporate ownership structures. Several typologies have been built to describe as globally as possible the situation of very different countries. A kind of competition has arisen between these typologies to describe more precisely the reality of business life. The purpose of this paper is to identify the relevant governance system typologies in five major European countries (France, Germany, Italy, Spain and the United Kingdom). To test the robustness of the typologies, we study transfers of ownership rights that may be an important determinant of corporate governance. We focus on transfers of ownership rights because La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) (LLSV, 1998) in their analysis of legal and financial systems of 49 countries do not consider them and because other more recent studies only focus on cross-country mergers and acquisitions (M&A) (Rossi and Volpin, 2004).

To achieve our goal, we use Zephyr database, which contains information on multiple deals types including M&A activity, Initial Public Offerings (IPOs), joint ventures, and private equity deals with links to companies' financial information. We focus on five European countries because their Gross Domestic Products are the highest in Europe and

because their corporate governance models still remain different despite the European integration process.

We structure the paper as follows: Section 2 identifies the factors that may explain differences in transfers of ownership rights across European countries. Testable hypotheses are identified to assess the robustness of corporate governance systems typologies. Section 3 describes the data and the methodology. Section 4 contains the results. Section 5 discusses them in relation with the relevance of corporate governance systems typologies. Section 5 concludes.

2. Factors of differentiation in transfers of ownership rights across European countries

In an economy without any imperfection, transfers of ownership rights would be driven only by opportunities for maximising value. In such a perfect world, sellers would maximize the shares' value and acquirers would improve the efficiency of firms by taking over new branches. Imperfections such as asymmetries of information and agency conflicts can prevent efficient transfers of shares. More precisely, the financial and legal environment within a country could have a significant impact on transfers of ownership rights. In this section, we first position the five countries studied within the main classifications of European economies in order to differentiate

between them (2.1.). Second, we identify the theoretical impacts of these factors of differentiation on the characteristics of transfers of shares (2.2.). In conclusion, we formulate testable hypotheses (2.3.)

2.1. Definition of corporate governance systems

We retain three dimensions to define a typology of corporate governance systems: the financial system, the legal and regulatory regime and the corporate ownership structures.

2.1.1. The typology of financial systems

Traditionally, two systems are opposed: bank-centered systems versus financial market-based systems²⁰ (Gerschenkron, 1962; Rybczynski, 1984; Levine, 1997; Allen and Gale, 1999). In bank-centered systems such as Germany and Japan during the 1960-1980 period, banks play a major role in the collection of financial resources, the allowance of capital, and the definition of the firms' investment plans. In market-based systems such as the Anglo-Saxon countries, securities market plays an important role besides banks in the collection of resources and their assignment, which makes investment less sensitive to banking debt (Demirgüç-Kunt, Laeven and Levine, 2004).

This classification has been called into question by Mayer (1988), and Corbett and Jenkinson (1997). Using net financial data (new debts minus reimbursement of existing debts and banking deposits), these authors do not find any significant difference in the way companies of the most developed countries are financed. Self-financing is the most important financing source everywhere, and then, among external financial resources, debt, in particular from banks, is the most used financing source (except for Canada). Schmidt, Hackethal and Tyrell (1998, 2002) have recently disputed these results. According to them, Mayer's results and those of Corbett and Jenkinson are mainly due to a statistical artefact related to the use of net data. When these authors use gross data from national accounts, they do not confirm Mayer's results and show that significant differences still exist in the financing structures: on the one hand, Germany is still very centred on banking debt and, on the other hand, the UK still relies on financial markets for its external financings. For France, the authors show a radical transformation of the financing system, which could converge during the 1981-1996 period towards the British system.

Demirgüç-Kunt and Levine (1999) also find significant differences in financial structures for a sample of 150 countries during the 1990s. They

reckon an index of financial development and show a segmentation of countries into two classes, which correspond to the traditional classification between bank-centred and market-based economies. According to this work, France, Germany, Italy, and Spain belong to bank-centred economies whereas the UK belongs to market-based ones.

This classical analysis of financial systems has been recently amended. On the one hand, the development of banking activities on financial markets shows some limits to the efficiency of this approach, which opposes banks to markets. On the other hand, according to LLSV (2000), this classification is indeed no longer effective to distinguish between financial systems. Another approach, developed by LLSV (1998), takes into account the nature of the legal regimes, which offer a legal and regulatory framework for financial activities, to discriminate between countries.

2.1.2. The typology of legal regimes

As financing is a matter of contracts and transfer of information, the nature of the legal regime is crucial to define corporate governance models. In particular, the ability of the legal system to protect creditors and shareholders and its enforcement power are essential criteria for the development of financial activities.

More precisely, LLSV (1998) oppose two types of legal systems. The regime of common law, based on the Anglo-Saxon tradition, ensures a very strong protection to both shareholders and creditors, whereas the regime of French civil law, which derives from the Roman law, offers a low degree of protection to external investors. The regime of German and Scandinavian civil law is intermediate between them. In this typology, Italy and Spain have the same legal regime as France, namely a French civil law. These differences in legal systems induce different firms' behaviours in terms of ownership and control, which are, according to Franks and Mayer (1994), the main distinguishing factors between corporate governance models.

2.1.3. The typology of corporate ownership structures

It is widely documented that corporate ownership structures vary across the large European economies (Barca and Becht, 2001 and Faccio and Lang, 2002). In most European countries, ownership structures are highly concentrated. Some authors argue that the deficiencies in national corporate governance structures are mitigated by higher concentrations of ownership. For instance, La Porta et al. (1999, 2000) argue that the concentration of shareholdings is indeed a rational response to the lack of protection of investors in a given country. If the law does not protect owners against controllers, owners will seek to be controllers. The authors indicate that, in this situation, agency conflicts between managers and shareholders are not significant because large shareholders have at the same time the incentive and

²⁰ Following Hicks (1975), we can also oppose "auto economy" (Anglo-Saxon countries), where companies are self-financed, and "overdraft economy", where liquidity is based on banking overdraft (Germany and Japan).

the ability to control the management. The authors, however, point out that a high concentration of shareholdings leads to an agency problem between the majority shareholders and the minority ones. According to other authors, political determinants also explain differences in ownership concentration (Roe (2003), Pagano and Volpin (2001), Pollin and Vaubourg (2006)).

Studies show a higher concentration of shareholdings in Germany (Franks and Mayer, 1994; Gorton and Schmid, 2000), in France (Bloch and Kremp, 1999), in Italy (Barca, 1995), and in Spain (Crespí-Cladera and García-Cestona, 1999). On the contrary, for the UK, a great number of firms are listed on the Stock Exchange and the majority of them have a dispersed shareholding.

For France, the distinctive characteristics of ownership structure are a high concentration, family shareholdings and the important role played by holding companies, the two last characteristics being closely dependent. Concentration of shareholdings is high for both unquoted companies and companies in the CAC 40 index. Family shareholdings are significant, whereas stakes held by banks, insurance companies and other financial institutions are relatively low, except for CAC 40 firms.

For Germany, the concentration of shareholdings is historically high because banks have played an active part in the German industrialization and they still hold large stakes in the largest companies (Roe, 1994). Important reforms, however, have been launched during the second half of the nineties and they may call into question this situation.

For Italy, ownership structure is characterized by a high concentration with a small number of powerful industrial families holding large stakes in large companies. However, since the end of the 1990s, new laws have been introduced in order to modify corporate governance. In particular, thanks to the Draghi law, investors' protection has improved, the development of the Italian financial market has accelerated and concentration of ownership has decreased.

For Spain, concentration of ownership is traditionally high. Non-financial companies are the largest investors. Banks' shareholdings, historically high, have decreased but still remain significant in some sectors as Banking and Communication. State's shareholdings, that were significant in some sectors and many large companies until 1995, have almost disappeared since 1998.

In Continental Europe, the concentration of ownership is hence rather high but some studies show some differences across countries. Boutillier et al. (2002) find on a sample of quoted firms that the largest shareholder holds on average almost half of the capital in France and in Germany. In Italy, the largest shareholder of a quoted firm owns about 40 % of the shares, whereas in Spain and in the United Kingdom, he or she holds nearly 20 %. In a study by Kirchmaier and Grant (2005), Spain also appears as

an outlier in Continental Europe in terms of ownership structure. They find that the predominant investor type of the largest public companies is family ownership in France, Germany and Italy, whereas corporate and financial owners are the most prominent in Spain. They also show that large Spanish firms have more in common in terms of dispersed ownership structures with the UK than with Continental Europe.

On the whole, we can oppose the UK to Italy. In the UK, the financial system is based on financial markets, the legal regime is ensuring a good protection for investors and concentration of ownership is low. On the contrary, in Italy, financial systems are based on banking debt, the legal regime is protecting poorly investors and concentration of ownership is high. The French, German and Spanish cases are less clear. They are three intermediate cases. First, in Germany, the legal system ensures a better investors' protection, which distinguishes its governance system from the French, Italian and Spanish ones. Second, in France, corporate financing has recently changed: for more than 15 years, the French system has lost most of the characteristics of a bank-oriented economy and has begun to become a market-based economy. Third, concentration of ownership is lower in Spain than in France, Germany and Italy. Spain, however, has the same type of legal system as France and Italy.

2.2. Effects of different corporate governance systems on transfers of ownership rights

The nature of a financial system, namely the importance of markets relative to banks, may have an influence on transfers of ownership rights across countries. In market-based economies, transfers of ownership rights should more often rely on initial public offerings (IPOs) and should more often involve quoted firms. In addition, higher informational standards can reduce information asymmetries between managers and outside investors, which should favour transfers of shares on external markets. Consequently, on the one hand, the volume of deals should be higher in market-based economies and they should be more frequently paid in shares. Moreover, Management Buy-Ins (MBIs) should be more numerous in market-based economies, whereas Management Buy-Outs (MBOs) should be more widely used in bank-centred economies. We also expect that debt financing and payments in cash should be more frequent in bank-oriented economies than in market-based economies. Within the framework of this traditional classification, the role of private equity firms is ambiguous. Although private equity firms are financial institutions like banks, their activities require active financial markets in order to facilitate their exit and the rotation of their stakes. As a consequence, we cannot formulate any assumption

relative to the activity of private equity firms on the market of transfers of shares across countries.

The nature of legal origin can also have an influence on transfers of ownership rights. In spite of globalisation and European Unification, Rossi and Volpin (2004) find indeed that differences in legal systems still have a significant impact on M&A across countries. They show significant relations between the origin of the legal system and some characteristics of cross-border M&A. Based on the typology established by LLSV, they show that volumes of deals are higher in countries with higher informational standards and better shareholders protection, namely in countries with common law as the legal origin. According to these authors, payments in cash are more frequent in countries with better investor protection.

Other studies stress relationships between transfers of ownership rights and concentration of ownership. Thus, according to Shleifer and Vishny (1986), transfers of control are easier in companies with more concentrated ownership structure because they overcome the free-rider problem in takeovers. Indeed, when ownership is dispersed, each shareholder of the target company, if success is anticipated, hopes to benefit from a future increase in share value, which could be higher than an immediate purchase of shares. According to Grossman and Hart (1980), in this case, each target shareholder wants to become the free-rider of the bidder, that is to benefit completely from the improvements the acquirer intends to bring to the firms' operations. Rossi and Volpin's results (2004) corroborate this hypothesis since they show that countries with a higher concentration of ownership have more M&A.

According to Bolton and Von Thadden (1998), corporate acquisitions and concentration of ownership are two different ways for controlling managers. Lower concentration of ownership makes financial markets more liquid and thus facilitates takeovers. Consequently, according to this argument, acquisitions (in particular, hostile ones) should be more numerous in countries with dispersed ownership as they are easier to implement. In addition, differences in concentration of ownership across countries can also have an impact on deals types. Shleifer and Wolfenzon (2002) affirm that concentration of ownership characterizes countries with lower investor protection because companies have no opportunity to sell shares to minority shareholders when investors are not well protected by law. Transfers of minority stakes should be less frequent in countries with higher concentration of ownership.

2.3. Synthesis of testable hypotheses

We can, first, derive seven hypotheses from the analysis of the typology based on the type of financial system.

H1: IPOs should be more frequent (H1a) and transfers of ownership should involve more frequently

quoted firms (H1b) in market-based economies than in bank-centred economies.

H2: The volume/value of deals should be higher in market-oriented economies than in bank-centred economies.

H3: Payments in shares should be more frequent in market-based economies (H3a), whereas payments in cash should be more frequent in bank-centred economies (H3b).

H4: MBIs should be more frequent in market-oriented economies (H4a), whereas MBOs should be more frequent in bank-centred economies (H4b).

H5: Bank financing should be more significant in the financing of transfers of shares in bank-centred economies.

H6: Private equity firms' activity requires the existence of an active financial market where shares can be sold.

Then, three other hypotheses come from the analysis of legal regimes.

H7: The volume/value of transfers of shares should be higher in common law countries.

H8: Payments in cash should be less frequent in countries with higher shareholder protection (common law).

H9: Private equity firms' activity should be more developed in countries with lower investor protection (civil law).

Finally, two hypotheses derive from the analysis of corporate ownership structures.

H10: The volume/value of transfers of shares should be higher in countries with higher concentration of ownership.

H11: Transfers of minority stakes should be less frequent in countries with higher concentration of ownership.

3. Methodology

To test these hypotheses, we conduct unidimensional and bidimensional analyses on a sample that contains deals, corresponding to sales of shares, completed between 1996 and 2004, involving targets from France, Germany, Italy, Spain and the United Kingdom, and reported by Zephyr, a database from Bureau Van Dijk. We first describe the database and the sample's features. Second, we present the variables used in our study and third, we introduce our method to assess the relevance of the different typologies.

3.1. Population and sample selection

Zephyr database from Bureau Van Dijk contains information on various types of deals including mergers and acquisitions, initial public offerings (IPOs), joint ventures and private equity deals, with no minimum deal value. Over 260,000 transactions are included since 1996²¹.

²¹ The availability of data varies with deals' types.

Our sample contains all deals corresponding to transfers of shares' ownership, completed as of May 5, 2004, and reported by Zephyr, a database from Bureau Van Dijk. Because we wish to study all transactions that create transfers of ownership rights, we select mergers (business combinations in which the number of companies decreases after the transaction), acquisitions of majority interests (all cases in which the acquirer ends up with 50% or more of the votes of the target), transfers of minority stakes (below 50%), leveraged buy-outs (LBOs), and IPOs, which involve targets (companies being sold, or companies in which a stake is being sold) from France, Germany, Italy, Spain and the United Kingdom. We thus obtain 47 942 deals. The availability of targets' turnover before the deal limits our sample's size to 21 155 deals. In interpreting the results, we note that it is important to be aware that the availability and quality of the data may be better in the United Kingdom because of broader Zephyr coverage. Moreover, the coverage of a country seems to improve over time. The sample is redressed so that it is representative of the total population according to the target's country before the filters are applied to select the sample.

3.2. Description of variables

For the variables that allow multiple answers, we retain only the main answer. For instance, if a deal is financed by both capital increase and debt, then we retain only the main financing resource.

We first consider variables that describe the deal's characteristics. First, the deal type is included: acquisitions of majority interests (above 50%) are distinguished from MBOs, MBIs or IBOs (Institutional Buy-Outs, that is LBOs, in which a private equity firm takes the majority stake), mergers and demergers, IPOs, and transfers of minority stakes (below 50%). Second, the deal's financing distinguishes between capital increases, debt and financing by private equity firms (specialized in venture capital or development capital, possibly joined by a standard company). Third, the deal's method of payment indicates whether the price is paid in cash, by shares, by debt or with an earnout.

We then identify variables that describe the characteristics of the target and those of its acquirer. The following variables are included: the target and acquirer countries, and their respective activities and quotations. A continuous variable, the deal value, is also introduced.

3.3. Assessment of typologies

To assess the relevance of typologies, we reckon a score for each one by comparing the number of accepted hypotheses to the total number of testable hypotheses. We exclude the hypotheses for which results are indeterminate.

4. Results

Results from unidimensional analysis (appendix 1) show a significant number of deals, in relation to the whole sample, involving British targets. On the 21,155 deals studied, 48.92% involve British companies, 16.52% French companies, 16.16% German companies, 10.55% Italian companies, and 7.82% Spanish companies. Thus, results are in line with the hypotheses (H2) and (H7), which expect a more important volume of transfers of shares, respectively, in market-centred economies and in common law legal systems. The hypothesis (H10), which expects a larger volume of deals in countries with a high degree of ownership concentration, is however refuted.

The bidimensional analysis (appendix 2) enables us to go further by linking the deal value and the target country. Results show a significant relation between these two variables. Two particular relations explain this result: the positive relation between the deal value and Germany and the negative relation between the deal value and the United Kingdom. Although the volume of deals is larger for the United Kingdom, in relation to the whole sample, Germany involves larger deals in value and the United Kingdom smaller ones. This result is confirmed by the variance analysis of deal value by target country (appendix 3). Only two relations are significant (using a 5% threshold): the positive relation between the deal value and Germany, and the negative relation between the deal value and the United Kingdom. Hypotheses (H2) and (H7) are thus not verified when activity is measured in value. However, these results are in line with hypothesis (H10). Note, however, that Zephyr coverage of deals is probably not exhaustive and, that coverage, in particular for small deals, is certainly broader for the United Kingdom than for the others countries because of better informational standards (common law system). The bidimensional analysis also enables us to study the relation between the target country and several variables, namely acquirer country, target quotation, acquirer quotation, deal type, deal financing, and deal method of payment. The chi-square tests of independence show significant relations between the target country and each one of these variables except for the deal method of payment. The hypotheses, which link the target country and the deal method of payment (H3a, H3b, H8), are thus not corroborated. The significant relations between the target country and some other variables complete this result. The relation between the target country and its quotation highlights the importance, in relation to the whole sample, of:

- unquoted targets for France, Spain and the United Kingdom;
- quoted targets for Italy.

For Germany, there is no significant relation between these two variables.

The relation between the target country and the acquirer quotation highlights the importance, in relation to the whole sample, of:

- unquoted acquirers for France and Spain;
- quoted acquirers for Germany and Italy.

For the United Kingdom, there is no significant relation between these two variables. These results do not corroborate hypothesis (H1b), according to which transfers of shares involve more often quoted targets and acquirers in market-based economies, that is initially the United Kingdom. The relation between the target country and the deal type highlights the importance, in relation to the whole sample, of:

- transfers of minority stakes, IBOs, acquisitions (above 50%), IPOs for France and Germany;
- transfers of minority stakes for Italy;
- mergers-demergers and acquisitions for Spain.;
- mergers-demergers and MBIs for the United Kingdom.

The hypothesis (H1a), according to which transfers of shares involve more often IPOs in market-based economies, is once again not corroborated. The hypothesis (H11), according to which transfers of minority stakes are less frequent in countries with a high concentration of ownership, is also invalidated. On the contrary, the hypothesis (H4a) of the importance of MBIs in market-based economies is verified since this deal type is linked to the United Kingdom only. MBOs, however, are homogeneously distributed in the sample, whatever the target country: the hypothesis (H4b) of their overrepresentation in bank-centred economies is not verified.

The relation between the target country and the deal financing highlights, in relation to the whole sample, the importance of financing by private equity firms and the small use of debt for France and Spain. Germany and Italy are negatively linked to debt. The United Kingdom is positively linked to debt and other sources (including capital increases) and negatively to private equity financing. These results, in particular the slighter role of debt for Germany and its importance for the United Kingdom, are completely opposite to the expectations based on the traditional classification of financing systems (H5). The importance of private equity financing for France and Spain is in line with the need for financial intermediaries providing equity in economies with a low investor protection, especially for minority shareholders: hypothesis (H9) is thus verified.

5. Discussion

Using a large sample of transfers of shares, completed between 1996 and 2004, in five major European countries with different financial systems, we find a more important volume of transfers of shares, respectively, in market-centred economies, in common law systems, and in countries with a high concentration of ownership. This result, however, is

not confirmed when activity is measured in value, since the United Kingdom is negatively associated with the deal value.

We also find that there is no relation between the target country and the deal's method of payment, and that the transfers of shares in the United Kingdom, contrary to our expectations, do not involve more frequently quoted firms or IPOs. Moreover, we find that transfers of minority stakes are not less frequent in countries with a higher concentration of ownership, and that majority acquisitions are not more numerous in the countries with dispersed ownership. Concerning MBIs, we find that they are positively associated with the United Kingdom only, whereas MBOs are not associated with a specific country.

Results concerning deal financing indicate, contrary to our expectations, a slighter role of debt for Germany and a more important one for the United Kingdom. We also find that private equity financing plays an important role for France and Spain, which is in line with the need for financial intermediaries providing equity in economies with a low investor protection, especially for minority shareholders. All these results are summarized in Table 1.

Overall, our results invalidate, in their great majority, the expectations induced from the theoretical analysis of corporate governance systems, which is based on the three classical approaches (market-based versus bank-centred economy, origin of the legal system, and corporate ownership structures). The typology based on the legal regime appears to be the less bad one. But the three classical typologies are insufficient to distinguish between governance systems as they miss to capture institutional complementarities and political differences. Our results are in line with the analysis of Pollin and Vaubourg (2006) and suggest that the analysis of European corporate governance systems should take into account other national differences, such as labour market organization and productive system characteristics. Our unexpected results could also suggest a convergence of corporate governance systems, not towards the Anglo-American model, but towards a new model. We observe indeed that the deals involving British targets are significantly financed by debt. Germany is obviously no longer a pure bank-centred economy since there is a negative relation between this country and the debt financing.

6. Conclusion

The aim of this article was to address the question of the relevance of corporate governance systems typologies in Europe. We analysed transfers of ownership rights to assess the robustness of different competing typologies. Results contrast with the widely known typology based on the opposition between "market-based" and "bank-based" financial systems. We also take a critical look to the LLSV's thesis and to the typology of countries based on corporate ownership structures. Actually, the three

typologies miss to capture the implications of institutional complementarities on the ways firms are governed (Pollin and Vaubourg, 2006). Our study suggests that the analysis of European corporate

governance systems should take into account other national differences, highlighted by Vaubourg and Pollin (2006), such as labour market organization and productive system characteristics.

Table 1. Results of the test of hypotheses

Hypotheses	Results
Typology based on financial systems	
H1: IPOs should be more frequent (H1a) and transfers of ownership should involve more frequently quoted firms (H1b) in market-based economies than in bank-centred economies.	H1a: Refuted H1b: Refuted
H2: The volume/value of deals should be higher in market-oriented economies than in bank-centred economies.	Indeterminate
H3: Payments in shares should be more frequent in market-based economies (H3a), whereas payments in cash should be more frequent in bank-centred economies (H3b).	H3a: Refuted H3b: Refuted
H4: MBIs should be more frequent in market-oriented economies (H4a), whereas MBOs should be more frequent in bank-centred economies (H4b).	H4a: Accepted H4b: Refuted
H5: Bank financing should be more significant in the financing of transfers of shares in bank-centred economies.	Refuted
H6: Private equity firms' activity requires the existence of an active financial market where shares can be sold.	Refuted
Score =	1/8
Typology based on legal regimes	
H7: The volume/value of transfers of shares should be higher in common law countries.	Indeterminate
H8: Payments in cash should be less frequent in countries with higher shareholder protection (common law).	Refuted
H9: Private equity firms' activity should be more developed in countries with lower investor protection (civil law).	Accepted
Score =	1/2
Typology based on ownership structures	
H10: The volume/value of transfers of shares should be higher in countries with higher concentration of ownership.	Indeterminate
H11: Transfers of minority stakes should be less frequent in countries with higher concentration of ownership.	Refuted
Score =	0

There is an alternative explanation. Our unexpected results could also suggest a convergence of the systems, not towards the pure Anglo-American model, but towards a new model. We observe indeed that the deals involving British targets are significantly financed by debt. Germany is obviously no longer a pure bank-centred economy since there is a negative relation between this country and the debt financing. The question of convergence of systems will be analysed in a further study.

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Appendix 1. Descriptive statistics of nominal variables

Target country	Number	% / Total	% / Expr.
France	3 495	16,52	16,52
Germany	3 424	16,18	16,18
Italy	2 232	10,55	10,55
Spain	1 655	7,82	7,82
United Kingdom	10 349	48,92	48,92
Total	21 155	100,00	100,00
Target Zephus Classification			
	Number	% / Total	% / Expr.
Agriculture	68	0,32	0,32
Banking, Insurance	1 925	9,10	9,10
Biotechnology, Pharmacy	444	2,10	2,10
Chemicals, Petroleum	780	3,69	3,69
Communications	745	3,52	3,52
Computer, IT	3 358	15,87	15,87
Construction	343	1,62	1,62
Food & Tobacco Manufacturing	787	3,72	3,72
Hotels and Restoran	552	2,61	2,61
Industrial Electric	1 849	8,74	8,74
Leather Stone Clay	277	1,31	1,31
Metals & Metal production	580	2,74	2,74
Mining & Extraction	254	1,20	1,20
Miscellaneous Manufacturing	148	0,70	0,70
Personal, Leisure Services	2 924	13,82	13,82
Printing & Publishing	525	2,48	2,48
Property Services	432	2,04	2,04
Public Administration	374	1,77	1,77
Retailing	884	4,18	4,18
Wholesaling	1 045	4,94	4,94
Textiles & Clothing	347	1,64	1,64
Transport Manufacturing	438	2,07	2,07
Transport Freight	819	3,87	3,87
Wood	389	1,84	1,84
Utilities	430	2,03	2,03

Unknown	440	2,08	2,08
Total	21 156	100,00	100,00
Target quoted/unquoted			
	Number	% / Total	% / Expr.
Quoted	6 888	32,56	32,56
Unquoted	14 268	67,44	67,44
Total	21 155	100,00	100,00
Deal type			
	Number	% / Total	% / Expr.
Acquisition	10 286	48,62	48,62
Minority	3 986	18,84	18,84
MBO	243	1,15	1,15
IPO	1 046	4,94	4,94
IBO	469	2,22	2,22
MBI	883	4,17	4,17
Merger-Demerger	4 243	20,06	20,06
Total	21 155	100,00	100,00
Deal financing in classes			
	Number	% / Total	% / Expr.
Private equity	2 903	13,72	39,02
Debt	504	2,38	6,78
Others (incl. capital increase)	4 033	19,07	54,21
Total	7 441	35,18	100,00
Deal method of payment			
	Number	% / Total	% / Expr.
Cash	9 275	43,85	87,66
Converted Debt	20	0,09	0,19
Debt	237	1,12	2,24
Earn-out	29	0,14	0,27
Loan notes	92	0,44	0,87
Other	82	0,39	0,77
Shares	847	4,00	8,00
Total	10 581	50,02	100,00

Acquiror Zephus classification	Number	% / Total	% / Expr.
Agriculture	34	0,16	0,24
Banking, Insurance	4 756	22,48	33,70
Biotechnology, Pharmacy	194	0,92	1,38
Chemicals, Petroleum	337	1,59	2,38
Communications	371	1,76	2,63
Computer, IT	1 357	6,41	9,61
Construction	225	1,06	1,59
Food & Tobacco Manufacturing	403	1,90	2,85
Hotels and Restaurants	230	1,09	1,63
Industrial Electric	923	4,37	6,54
Leather Stone Clay	154	0,73	1,09
Metals & Metal production	304	1,44	2,16
Mining & Extraction	117	0,55	0,83
Miscellaneous Manufacturing	63	0,30	0,45
Personal, Leisure Services	1 489	7,04	10,55
Printing & Publishing	332	1,57	2,35
Property Services	210	0,99	1,49

Public Administration	160	0,76	1,14
Retailing	404	1,91	2,86
Wholesaling	131	0,62	0,93
Textiles & Clothing	252	1,19	1,79
Transport Manufacturing	492	2,33	3,49
Transport Freight	645	3,05	4,57
Wood	223	1,05	1,58
Utilities	307	1,45	2,17
Total	14 113	66,71	100,00
Acquiror quoted/unquoted			
	Number	% / Total	% / Expr.
Quoted	5 608	26,51	31,88
Unquoted	11 984	56,65	68,12
Total	17 592	83,16	100,00
Acquiror country			
	Number	% / Total	% / Expr.
France	2 355	11,13	13,98
Germany	1 933	9,14	11,48
Italy	1 293	6,11	7,68
Spain	1 149	5,43	6,82
United Kingdom	7 066	33,40	41,96
Others	3 044	14,39	18,08
Total	16 840	79,60	100,00

Appendix 2. Results from bidimensional analysis

Class: France							
Variables	Characteristical modalities	% of modality in the class	% of modality in sample	% of class in the modality	Value-Test	Probability	Weight
Acquirer country	Acquirer France	67.38	14.04	81.61	78.49	0.000	2362
Deal type	Minority	34.16	18.84	29.96	23.84	0.000	3986
Deal financing	Private Equity	64.59	39.02	23.92	18.30	0.000	2903
Deal type	IBO	4.73	2.22	35.26	9.87	0.000	469
Deal type	Acquisition	52.07	48.62	17.69	4.45	0.000	10286
Deal type	IPO	6.40	4.94	21.37	4.19	0.000	1046
Acquirer quoted/unquoted	Acquirer Non-Quoted	70.42	68.12	17.62	2.95	0.002	11984
Target quoted/unquoted	Unquoted	69.51	67.44	17.03	2.83	0.002	14268
Acquirer country	Acquirer others	19.08	17.66	18.37	2.17	0.015	2971
Target quoted/unquoted	Quoted	30.49	32.56	15.47	-2.83	0.002	6888
Acquirer quoted/unquoted	Acquirer Quoted	29.59	31.88	15.82	-2.95	0.002	5608
Deal type (Acq vs other)	Other	47.93	51.38	15.41	-4.45	0.000	10869
Deal financing	Debt	2.25	6.78	4.81	-7.14	0.000	504
Acquirer country	Acquirer Italy	2.40	7.70	5.29	-13.09	0.000	1296
Deal financing	Other	33.15	54.21	8.84	-15.01	0.000	4033
Deal type	MBI	0.22	4.17	0.87	-16.03	0.000	883

Acquirer country	Acquirer Spain	0.90	6.84	2.23	-16.51	0.000	1150
Acquirer country	Acquirer Germany	2.55	11.52	3.77	-18.99	0.000	1939
Deal type	Merger-Demerger	0.45	20.06	0.37	-39.48	0.000	4243

Class: Germany

Variables	Characteristical modalities	% of modality in the class	% of modality in sample	% of class in the modality	Value-Test	Probability	Weight
Acquirer country	Acquirer Germany	61.24	11.52	86.58	75.96	0.000	1939
Deal type	Minority	29.42	18.84	25.27	16.48	0.000	3986
Deal type	IPO	10.70	4.94	35.00	15.24	0.000	1046
Acquirer country	Acquirer others	24.62	17.66	22.71	10.07	0.000	2971
Deal type	IBO	3.67	2.22	26.76	5.77	0.000	469
Deal type	Acquisition	52.25	48.62	17.39	4.62	0.000	10286
Acquirer quoted/unquoted	Acquirer Quoted	35.52	31.88	18.14	4.55	0.000	5608
Acquirer quoted/unquoted	Acquirer Non-Quoted	64.48	68.12	15.41	-4.50	0.000	11984
Deal type (Acq vs other)	Other	47.75	51.38	15.04	-4.62	0.000	10869
Deal financing	Debt	2.85	6.78	5.53	-5.66	0.000	504
Acquirer country	Acquirer Italy	2.06	7.70	4.35	-13.86	0.000	1296
Deal type	MBI	0.21	4.17	0.83	-16.01	0.000	883
Acquirer country	Acquirer Spain	0.42	6.84	1.01	-18.05	0.000	1150
Acquirer country	Acquirer France	4.17	14.04	4.84	-18.28	0.000	2362
Deal type	Merger-Demerger	1.19	20.06	0.96	-36.59	0.000	4243
Acquirer country	Acquirer UK	7.49	42.24	2.89	-44.03	0.000	7108

Class : Italy

Variables	Characteristical modalities	% of modality in the class	% of modality in sample	% of class in the modality	Value-Test	Probability	Weight
Acquirer country	Acquirer Italy	68.05	7.70	85.03	70.86	0.000	1296
Deal type	Minority	60.04	18.84	33.63	46.42	0.000	3986
Target quoted/unquoted	Quoted	55.94	32.56	18.13	24.10	0.000	6888
Deal type (Acq vs other)	Other	66.58	51.38	13.67	15.32	0.000	10869
Acquirer quoted/unquoted	Acquirer Quoted	35.93	31.88	10.95	3.72	0.000	5608
Deal financing	Debt	4.36	6.78	2.92	-1.70	0.045	504
Acquirer quoted/unquoted	Acquirer Non-Quoted	64.06	68.12	9.14	-3.72	0.000	11984
Deal type	IPO	2.72	4.94	5.81	-5.42	0.000	1046
Acquirer country	Acquirer Spain	0.82	6.84	1.15	-12.36	0.000	1150
Acquirer country	Acquirer Germany	3.09	11.52	2.58	-12.82	0.000	1939
Acquirer country	Acquirer France	4.64	14.04	3.18	-12.86	0.000	2362
Deal type	MBI	0.00	4.17	0.00	-13.94	0.000	883
Deal type	Acquisition	33.42	48.62	7.25	-15.32	0.000	10286
Target quoted/unquoted	Unquoted	44.06	67.44	6.89	-24.06	0.000	14268
Deal type	Merger-Demerger	0.50	20.06	0.26	-30.78	0.000	4243

Acquirer country	Acquirer UK	6.89	42.24	1.57	-33.45	0.000	7108
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Class : Spain

Variables	Characteristical modalities	% of modality in the class	% of modality in sample	% of class in the modality	Value-Test	Probability	Weight
Acquirer country	Acquirer Spain	72.91	6.84	93.94	75.88	0.000	1150
Deal type	Merger-Demerger	41.66	20.06	16.25	20.96	0.000	4243
Target quoted/unquoted	Unquoted	78.21	67.44	9.07	10.00	0.000	14268
Acquirer quoted/unquoted	Acquirer Non-Quoted	73.34	68.12	9.33	4.63	0.000	11984
Deal financing	Private Equity	45.87	39.02	7.61	3.11	0.001	2903
Deal type	Acquisition	51.12	48.62	8.22	2.09	0.018	10286
Deal type (Acq vs other)	Other	48.88	51.38	7.44	-2.09	0.018	10869
Deal financing	Debt	3.66	6.78	3.49	-2.83	0.002	504
Deal type	IPO	3.09	4.94	4.89	-3.80	0.000	1046
Acquirer quoted/unquoted	Acquirer Quoted	26.66	31.88	7.25	-4.63	0.000	5608
Deal type	MBI	1.89	4.17	3.54	-5.31	0.000	883
Acquirer country	Acquirer others	12.34	17.66	6.15	-5.80	0.000	2971
Deal type	IBO	0.35	2.22	1.23	-6.34	0.000	469
Acquirer country	Acquirer Italy	2.22	7.70	2.54	-9.46	0.000	1296
Target quoted/unquoted	Quoted	21.79	32.56	5.23	-10.01	0.000	6888
Acquirer country	Acquirer France	4.45	14.04	2.79	-12.53	0.000	2362
Acquirer country	Acquirer Germany	2.22	11.52	1.70	-13.81	0.000	1939
Deal type	Minority	0.98	18.84	0.41	-24.14	0.000	3986
Acquirer country	Acquirer UK	5.86	42.24	1.22	-33.07	0.000	7108

Class: United Kingdom

Variables	Characteristical modalities	% of modality in the class	% of modality in sample	% of class in the modality	Value-Test	Probability	Weight
Acquirer country	Acquirer UK	79.82	42.24	91.22	101.27	0.000	7108
Deal type	Merger-Demerger	33.68	20.06	82.16	49.94	0.000	4243
Deal type	MBI	8.09	4.17	94.76	30.44	0.000	883
Deal financing	Debt	9.19	6.78	83.25	11.02	0.000	504
Deal financing	Others	59.17	54.21	67.03	10.85	0.000	4033
Target quoted/unquoted	Unquoted	69.80	67.44	50.63	7.13	0.000	14268
Acquirer country	Acquirer others	16.01	17.66	43.77	-5.38	0.000	2971
Target quoted/unquoted	Quoted	30.20	32.56	45.38	-7.14	0.000	6888
Deal type	IPO	3.33	4.94	32.92	-10.72	0.000	1046
Deal type	IBO	1.12	2.22	24.63	-10.81	0.000	469
Deal financing	Private Equity	31.64	39.02	49.79	-16.36	0.000	2903
Acquirer country	Acquirer Spain	0.24	6.84	1.67	-37.34	0.000	1150
Acquirer country	Acquirer Italy	0.45	7.70	2.79	-38.35	0.000	1296
Acquirer country	Acquirer Germany	1.28	11.52	5.38	-44.08	0.000	1939

Acquirer country	Acquirer France	2.20	14.04	7.58	-46.09	0.000	2362
Target country	Spain	0.00	7.82	0.00	-48.46	0.000	1655
Deal type	Minority	4.13	18.84	10.74	-56.68	0.000	3986

Relation between Target country and Deal method of payment

Frequency	France	Germany	Italy	Spain	United Kingdom	TOTAL
% line						
% column						
Shares	98	107	48	54	540	847
	11.6%	12.6%	5.6%	6.3%	63.8%	100.0%
	7.4%	9.3%	7.9%	6.9%	8.0%	8.0%
Others	1 229	1 049	554	723	6 179	9 735
	12.6%	10.8%	5.7%	7.4%	63.5%	100.0%
	92.6%	90.7%	92.1%	93.1%	92.0%	92.0%
TOTAL	1 327	1 156	602	777	6 719	10 581
	12.5%	10.9%	5.7%	7.3%	63.5%	100.0%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

KHI2 = 4.37 / 4 DEGREES OF FREEDOM

PROBA (KHI2 > 4.37) = 0.359 / V.TEST = 0.36

Effect of Target country on Deal value

Target country	NUMBER	WEIGHT	V.TEST
France			Non significant
Germany	2779	3423.65	4.26*
Italy			Non significant
Spain			Non significant
United Kingdom	9614	10349.08	-3.66*

* Statistically significant at 5 %

Appendix 3 – Results from Analysis of Variance

Target country	Number	Weight
France	1652	1448.40
Germany	1129	1393.64
Italy	965	773.60
Spain	996	832.32
United Kingdom	6991	7541.14

Variable	Number Weight	Mean Standard deviation
Deal Value (in M€)	11733 11989.30	214572.98 2444609.50

TARGET COUNTRY	V.TEST	COEFF.	STAND DEV	STUDENT	PROBA.
France	- 0.28	-16317.5498	59242.695	0.275	0.783
Germany	3.34	200991.2031	60074.602	3.346	0.001
Italy	0.85	64261.7891	75582.672	0.850	0.395
Spain	- 1.71	-125098.6953	73342.922	1.706	0.088
United Kingdom	- 3.23	-123836.7422	38328.496	3.231	0.001
Constant	8.77	275613.5625	31368.422	8.786	0.000

OWNERSHIP STRUCTURES AND CAPITAL ALLOCATION: EVIDENCE FROM ESTIMATING PRODUCTION FUNCTIONS UNDER ALTERNATIVE SPECIFICATIONS

Bersant Hobdari*

Abstract

New and rich panel data for a large and representative sample of firms are used to estimate the effect of ownership structures on capital allocation. This issue is examined in a production function framework under alternative specifications. Our estimates confirm differences in capital allocation across firm under different ownership structure. Furthermore, we find that: (i) most of Estonian firms operate at the wrong point on their production function (ii) insider owned firms suffer from under-investment, (iii) state and domestic outsider owned firms display over-investment (iv) there is evidence of widespread managerial discretion.

Keywords: Corporate Investment, Insider Ownership, Production Functions, Generalized Method of Moments

* *Department of International Economics and Management,
Copenhagen Business School, Denmark,
Porcelanshaven 24 A, 2000, Frederiksberg, Denmark.*

1. Introduction

Economic theory argues at length that a firm's ownership structure is an important determinant of its access to finance and cost of capital. Notably, it is believed that limited access to capital is one of the main obstacles to insider owned (*see endnote 1*) firms' creation (Dreze (1993), Putterman (1993), Bowles and Gintis (1996) and Dow (2003)). In turn, it is hypothesized that these firms would arise in industries where capital requirements per worker would be low. The argument goes that, as insider owners, especially non-managerial employees, are generally not wealthy they would rely on external financing in securing the needed capital. However, a combination of the structure of property rights and market failures, such as asymmetric information and moral hazard result in higher cost of capital and, consequently, credit rationing for these firms. The outcome of this phenomenon is that investment rates across firms of differing ownership structures would be differently affected by the availability of internal finance and, consequently, some firms might be operating in an under-capitalized position compared to firms under alternative governance structures.

In this paper, using new and rich panel data for a large and representative sample of Estonian firms, we investigate econometrically the effect of ownership structures on capital allocation. Fundamentally, we provide new empirical evidence on a topic that has attracted the attention of theoretical and applied economists, but for which there is little empirical evidence. The analysis performed relates to previous

empirical work on the efficiency of capital allocation through estimation of returns to scale in a production function framework. This work is then extended by checking the robustness of results through the use of alternative forms of the production function, namely Cobb-Douglas, Constant Elasticity of Substitution and Translog production function. A further contribution of the paper is that it is among the first attempts that provide a comprehensive analysis of the efficiency of capital allocation across ownership groups. Finally, by using data from one of the most advanced transition economies, it assesses the long-run viability of certain ownership forms. This is an important issue in light of the continuing debate in the literature on the efficiency of various ownership forms emanating from the extensive privatisation process in almost all transition economies.

In the next section we develop the hypotheses on the effect of ownership structures on capital allocation. This is followed by a discussion of the analytical framework and of the problems arising in estimation of production functions. In the fourth section the sample used in the analysis is described, while in the fifth the estimation results are reported and discussed. In the last section we conclude and discuss some implications of empirical findings.

2. Ownership Structure, Capital Allocation and Returns to Scale

Various theoretical arguments, emanating from advances in economics of information, have highlighted the impact of ownership structures in

determining access to finance, which, in turn, affects investment decisions and capital allocation. The outcome of this process is that firms under certain ownership structures are likely to operate as under-capitalized, while others as over-capitalized.

One group of firms likely to face higher likelihood of being more constrained than others in raising capital is insider owned firms. The literature on employee ownership stresses a host of factors such as member's wealth position, their time horizon, risk attitudes, goal structure and the structure of property rights (*see endnote 2*) in the firm that make employee owners prefer taking the residual in the form of higher income rather than investing it in the firm. This preference along with employee owners' potential aversion to accepting new members lead to potential goal conflict between insiders and outside providers of both equity and debt capital. In addition, the fact that most of these firms are small and not listed in the stock markets exacerbates informational asymmetries and makes access to desired capital more difficult. The net effect of the interaction of these factors could be that outside investors might be reluctant to invest in employee owned firms or, when they do invest, the risk premium they charge is substantially higher than the market one. Overall, disincentives to invest internally and barriers to raise capital externally might lead to employee owned firms under-investing. The implication of under-investment is that these firms will be operating in the increasing returns to scale region of the production function.

A substantial part of insider ownership is in the form of managerial ownership. An initial increase in managerial ownership is considered beneficial because it better aligns the interests of managers and shareholders and, consequently, lowers managerial discretion. However, at high levels, managerial ownership (*see endnote 3*) is associated with entrenchment and divergence of interests between managers and shareholders. In addition, high managerial shareholding creates incentives to issue overvalued securities at the expense of outside financiers. These factors might result in firms facing a higher price for external finance and, consequently, relying more on internal funds to finance valuable investment projects. In transition economies, managerial shareholding in post-privatization ownership configurations, in the form of majority, dominant or minority shareholders, is substantial. The possibility of entrenchment and subsequent rent seeking or asset stripping behaviour on the part of managers has been an argument against managerial ownership. The likelihood of this happening depends to a large extent on managers' outside career opportunities and portfolio diversification, the way they obtain shares and the efficiency of market for corporate control. When outside career opportunities do not exist and managers have invested most of their human and financial capital in the firm, they will try to hold on to their equity share by following policies, including investments, which will increase

their job security. Furthermore, manager's behaviour might be fundamentally different depending on whether he/she acquires the firm through a managerial buy-out (MBO) or gets it either for free or in the framework of a voucher-funded privatization. If the ownership is gained through one of the latter two cases, the manager might perceive it as a windfall gain and consume it faster than earned income (Djankov (1999)). On the contrary, MBOs serve as screening mechanisms that allow only highly qualified, growth oriented (*see endnote 4*) managers to become owners (*see endnote 5*). In addition, independently of the way they gain ownership, managers will have incentives to pursue their interests at the expense of minority shareholders. Finally, markets for corporate control serve as disciplining devices for managers. However, as Earle and Estrin (1996) point out, in an environment of high uncertainty and infantile capital markets, informational asymmetries might lead to adverse selection problems in the market for corporate control. These arguments imply that, in a transition economy environment, ownership concentration in the hands of managers is likely to lead to managers' entrenchment, which in itself exacerbates informational asymmetries and leads to more expensive external finance and less investment.

In addition to under-investment, certain types of firms might be prone to over-investment. This would be the case in firms where the existence of insufficient monitoring mechanisms leads to high managerial discretion. As manager's interests might be driven by empire building and personal satisfaction rather than shareholder value maximization this will result in them engaging in unprofitable investment projects or in even projects with negative net present value, which might result in over-investment. The implication of over-investment is that these firms will be operating in the decreasing return to scale region of the production function. As over-investment depends then on managerial discretion, it is conjectured that firms with highly dispersed outside ownership, and, consequently, more managerial control, are more likely to experience over-investment. Yet, the existence of an outside core owner that owns more than 50% of the shares in the firm does, in principle, provide the necessary mechanism through which managerial discretion can be kept under control. Whether outside majority shareholding translates into managerial discipline will depend on how active these outsider majority shareholders are in their monitoring role, which in itself will depend on the identity of majority shareholders.

When majority shareholders are foreigners, who possess enough experience and resources to engage in effective monitoring, managerial discretion will be kept at minimal levels and, consequently, over-investment will not be an issue. When majority shareholders are domestic outsider investors the degree of effective monitoring will depend on the identity, number and size of investors. Depending on

the combination of these factors several scenarios might arise. On the one hand, if majority ownership is concentrated in the hands of a few big institutional investors with experience, resources and low coordination costs, then effective monitoring will arise. On the other hand, if majority ownership is concentrated in the hands of a large number of small investors, possibly individuals, then managers are more likely to enjoy substantial discretion in pursuing their objectives and arguments that lead to over-investment will apply. In between these two situations lie a host of other scenarios resulting in different degrees of managerial discretion that might or might not give rise to over-investment problem. Given that in the sample we have no data either on the identity or on the number and size of domestic outsider investors, we can not make ex ante predictions on whether firms dominated by domestic outsiders will display over-investment or not. Finally, when majority ownership is concentrated in the hands of the state (see endnote 6) managers will possess virtual control of the firm and enjoy high degrees of discretion in pursuing their interests. As such state owned firms would be likely to display over-investment. The implication of over-investment is that these firms will be operating in the decreasing returns to scale region of the production function.

A mitigating force to managerial discretion in non-insider dominated firms is the availability of external finance. In a transition economy like that of Estonia, although the availability of external finance has been increasing over time, it is still limited relative to GDP. This would result in fierce competition for external financing and in, probably, all domestic firms, independently of governance structure, experiencing some degree of financing constraints (see endnote 7). This argument implies that, in the case of non-insider dominated firms, more specifically of state and domestic outsider dominated firms, whether they operate in the increasing or decreasing returns to scale region of the production function will depend on the net effect of managerial discretion, or the effectiveness of monitoring mechanisms, and access to external finance. Yet, even if these firms experience under-investment, its degree would be more limited than that of insider dominated firms.

3. The Analytical Framework

The analysis starts with the assumption that a specified relationship exists for every firm between output, expressed as firm sales, and inputs employed in production, of the following form: $V = F(K, L, A)$ where V denotes sales, K and L denote quantities of capital and labour used in production and A is an index of technical change. Estimating returns to scale requires the operationalization of this relationship. Depending on the assumptions of the properties of such functions,

different functional forms have been proposed in the literature. Here the following alternative forms of the production function are adopted: Cobb-Douglas, Constant Elasticity of Substitution and Translog (see endnote 8).

Although based on highly restrictive assumptions, the Cobb-Douglas production function, is the most frequently used in empirical studies. Its estimable version takes the following form:

$$\ln(V/L) = \ln A + r \cdot T + \alpha \cdot \ln(K/L) + (\alpha + \beta - 1) \cdot \ln L + u \quad (1)$$

where α and β are output elasticities with respect to inputs, r is the average rate of Hicks neutral technical change, T is a time index and u is a standard disturbance term. A positive and significant coefficient on $(\alpha + \beta - 1)$ will confirm the presence of increasing returns to scale while a negative and significant coefficient on $(\alpha + \beta - 1)$ will confirm the presence of decreasing returns to scale.

Although very convenient in estimation, this form of the production function has the disadvantage of being very restrictive in that it limits all partial elasticities of substitution be equal to one. This restriction is relaxed in the Constant Elasticity of Substitution function of Arrow et. al. (1961), that, as the name shows, limits partial elasticities of substitution to be constant and equal for any input pair, but not always equal to one. Its estimable version is the following:

$$\ln(V/L) = \ln A + r \cdot T + (\eta - 1) \cdot \ln L - \frac{\eta}{\rho} \cdot \ln \left[\delta + (1 - \delta) \cdot \left(\frac{K}{L} \right)^\rho \right] \quad (2)$$

where δ is the distribution parameter, ρ is the substitution parameter and η is the elasticity parameter. The linear estimation of equation (2) is, however, not possible unless the term in brackets is approximated by a linear function. Following Kmenta (1967), this term is approximated by a second order Taylor series expansion around the point $\rho = 0$. Then, the estimating equation becomes the following:

$$\ln(V/L) = \ln A + r \cdot T + (\eta - 1) \cdot \ln L + \eta \cdot (1 - \delta) \ln(K/L) - \frac{1}{2} \cdot \rho \cdot \eta \cdot \delta \cdot (1 - \delta) \cdot \left(\ln(K/L) \right)^2 + u \quad (3)$$

The test for increasing (decreasing) returns to scale then becomes a test for positive (negative) and significant coefficient of $(\eta - 1)$. Inspecting equations (1) and (3), it can also be seen that a significant coefficient on the last term in equation (3) points to the rejection of the Cobb-Douglas function. This means that, except for testing the returns to scale parameters, equation (3) serves to discriminate which of the two models fits the data better.

The development of both Cobb-Douglas and Constant Elasticity of Substitution functional forms rests heavily on the assumptions of homotheticity and

separability, which lead to elasticities of substitution being constant for any pair of inputs. Christensen et al. (1973) propose a functional form that is independent of these assumptions and does not constraint elasticities of substitution in any way. For our general specification this functional form will be a translog second order approximation (*see endnote 9*) to the logarithm of V , as introduced, for instance, by Chan and Mountain (1983), as follows:

$$\ln V = a_1 + a_2 \cdot T + a_3 \cdot T^2 + a_4 \cdot (\ln K - \ln L) + a_5 \cdot \ln L + a_6 \cdot [(\ln K)^2 - \ln K \cdot \ln L] + a_7 \cdot [(\ln L)^2 - \ln K \cdot \ln L] + a_8 \cdot T \cdot (\ln K - \ln L) + u \quad (4)$$

If $a_5 = 1$ the production functions displays constant returns to scale, if $a_5 > 1$ it displays increasing returns to scale and if $a_5 < 1$ it displays decreasing returns to scale.

The parameters of interests in each equation are: a_4 in the Cobb-Douglas equation, a_3 in the Constant Elasticity of Substitution equation and a_5 in the Translog equation.

A central, well-known problem in estimation of production functions is simultaneity bias (*see endnote 10*), leading to inconsistency of OLS estimates. Alternative estimation methods proposed in the literature are Instrumental Variables and Generalized Method of Moments (GMM) estimators. A recurring problem with the latter two estimators is that the available instruments for the first difference in inputs might be weak and possess little explanatory power. A robust estimation approach, which explicitly accounts for input endogeneity, is the one developed by Olley and Pakes (1996). This method uses an investment proxy to control for the correlation between input levels and the unobserved productivity shock. Levinsohn and Petrin (2003) extend this method by showing that the use of intermediate inputs also corrects for the endogeneity problem. Further, the use of intermediate inputs is superior to that of investment proxy in samples of firms reporting zero or negative investment.

A further source of bias in the estimation of scale parameters from a production function specification is the use of deflated sales instead of real output as the dependent variable. This approach implicitly assumes that all firms within the same industry charge the same price. Price dispersion, however, even in narrowly defined industries, in the presence of imperfect competition is a major source of firm heterogeneity. Klette and Griliches (1996) show that there exist a systematic relationship between the price a firm charges and its inputs' growth. This relationship depends on idiosyncratic shocks to both factor prices and productivity, as well as demand shocks. The cost of not accounting for the effect of omitted output price variable is that the estimated scale elasticities would be a mixture of real scale elasticities and demand side elasticities and be,

consequently, downward biased. Although instrumental variable approach would seem the appropriate way to solve this issue, it is not trivial finding instruments that are correlated with inputs or their growth, but not with the omitted output price. Klette and Griliches (1996) solve for the omitted output price variable by including total industry's output as independent variable in the production function specification (*see endnote 11*).

4. Sample Description and Variable Definitions

The data used in this paper consist of annual firm-level observations of a sample of Estonian firms over the period 1993 through 1999. The sample is created through a combination of data obtained from surveys, which gather information on ownership configurations, and from standard firm financial statements reported to the Estonian Statistical Office. The firms included in the survey scheme are selected as a stratified random sample based on size and industry. Before carrying out the analysis we address measurement error issues by adopting several criteria to examine consistency of our data (*see endnote 12*). The application of all these criteria results in our using in the analysis a data set consisting of 3294 observations over the whole period 1993 through 1999.

Sample firms are classified into six ownership (*see endnote 13*) groups according to the dominant owner: domestic outsider, employee, former employee, foreign, manager and state. Table 1 presents the distribution of firms by ownership group over time. The data show that insider ownership, i.e., employee and manager, emerged as an important form of privatization. For example, in 1995 in more than 22% of cases, insiders or former insiders are dominant owners. This provides evidence to the importance of insider ownership during the early years of transition. Determining whether this is the outcome of the privatization process or of the entrepreneurial spirit that leads insiders to establish their own companies requires data on the origin of the firms. From the respondents' replies a lot of firms show up as being new ones. Yet, this might partly come due to the fact that insiders establish a company that takes over the assets of a former state owned enterprise. In this case it would be a mistake to classify the firm as new. Foreign owned companies comprise around 12% of the sample, with most of them being new companies established in the early 1990s, while domestic outsider owned firms comprise around 18% of cases. Finally, state owned firms account for around 48% of the sample, with 232 firms being 100% state owned while 30 firms are mostly in private hands but with the state still holding a dominant position.

Table 2 presents summary statistics of the most relevant variables used in the analysis. One observation emerging from both of these tables is that investment levels are high relative to capital stock,

with investment/capital ratio ranging from 0.17 in 1993 to 0.34 in 1995 for the unbalanced panels and from 0.17 in 1993 to 0.36 in 1995 for the balanced panel. We also see that average employment decreases while real wage increases over time, that cash flow is positive, that short-term debt increases over time and that cash flow and short-term debt are approximately the same magnitude in most years. The increase in debt after 1995 is consistent with the general increase of lending to the private sector during this period in Estonia. Furthermore, up to 1997, the sum of cash flow and short-term debt is less than investment suggesting that firms might have had access to other sources of capital such as short-term trade credit and/or long-term debt. This conjecture is supported by the last two rows of the table that show current payables and long-term liabilities, which include long-term loans as well as any other long-term debt a firm accumulates. The rate of growth of long-term liabilities is not high, except for the last year in the unbalanced panel, suggesting that long-term liabilities do not constitute an important source of capital over the stated period. Current payables, however, are quite high and higher than investment over the whole period, suggesting that they have been an important source of financing especially during the early years of the transition. Another important feature of Estonian firms during this period is that, on average, they have become more capital intensive as demonstrated by the increase in capital and the decrease in employment.

5. Empirical Results and Discussion

This section reports and discusses the results of estimating equations (1), (3) and (4). In estimation each equation is augmented with a vector X consisting of industry and time dummies designed to capture industry and economy wide specific effects common to all firms such as a banking crisis, shocks to exchange rate, demand shocks, industry idiosyncratic productivity shocks, etc. Furthermore, to correct for the correlation of inputs quantities and output price present in the deflated sales variable all the specifications are estimated with the total industry output included as a right hand side variable.

The hypothesis of significant differences in returns to scale parameter across firms with various governance structures could be tested in two ways. One way is to pool the whole sample together and introduce dummy variables that will take the value one if a given firm belongs to a given ownership group and zero otherwise. While accounting for the ownership effect on firm productivity, this approach imposes the restriction that all input elasticities are the same across ownership groups, with differences in performance captured only by differences in intercept terms. Relaxing this restriction, all dummies could be interacted with all other variables in the regression allowing not only the intercepts but also slopes to differ across groups. A disadvantage of this approach

is that the number of parameters to be estimated increases substantially. For example, leaving the state owned firms as the control group, the Cobb-Douglas specification will have 20 more parameters to be estimated, i.e., five dummy variables denoting the other ownership groups and their respective interactions with T , $\ln(K/L)$ and $\ln L$. The test on returns to scale for a given ownership group would then be a test on the significance of the sum of two parameters, i.e., the coefficient a_4 and the coefficient in front of the interaction of the respective ownership variable with $\ln L$. With large enough samples, however, the estimates would still be unbiased and consistent and all tests performed would be valid.

In addition to the increase in the number of parameters to be estimated, this approach suffers from further problems. First, when data are pooled the variance of the residual is forced to be the same across groups. A more serious problem though is the endogeneity of ownership, i.e., in equilibrium different owners will determine their optimal ownership share based on various firm characteristics, among which is firm productivity. If unaccounted for this problem will lead to inconsistent estimates. The solution to such problems is the application of IV techniques where appropriate instruments are found that are highly correlated with the ownership dummies but not correlated with the error term (*see endnote 14*). Finding such instruments, however, is not easy. The literature on determinants of ownership structures suggests that variables such as firm profitability, labor productivity, capital intensity, current and future financing requirements, firm size as well as industry specific variables, all appropriately lagged, would serve as instruments for ownership dummies. Yet, this procedure imposes heavy requirements on data and, given the discussion above on the endogeneity of inputs, identification problems might arise.

A solution to this issue would be to divide the sample into sub-samples of firms belonging to a given ownership group and then carry out the estimation for each group separately. In adopting this strategy, it is implicitly assumed that the ownership effect is constant across firms within each ownership group, i.e., that while there is between group variation in ownership effect, there is no within group variation. This might be a reasonable assumption in that owners of the same type are, on average, expected to behave similarly. However, even within each individual group there are differences in ownership structures across firms that might lead to differences in observed behavior. For instance, it is conjectured that the monitoring of management on the part of owners would be more effective the higher the share they own in the firm. This means that, managerial discretion would be more limited in a firm where dominating owners, other than the managers themselves, own, let us say, 80% of the shares than in a firm where dominating owners own just 35% of the shares.

Furthermore, the higher the share owned by employees the more pronounced the under-investment problem might be. The implication of these arguments is that, grouping firms into ownership clusters based only on owners' identity and not on the degree of concentration of ownership, i.e., percentage of shares held by the largest owner, overlooks important differences within each cluster and leads to imprecise inferences. Yet, we do not expect our results to be affected by the separating criteria we have used. The reason is that, 87% of firms in the sample have a clear majority owner. This pattern is similar across ownership groups, with the lowest share of firms having a clear majority owner being 75% for employee owned firms, while the largest being 99% for state owned firms. This makes it reasonable to assume that owners of the same type behave similarly and, in turn, within group ownership effect will be the same. Idiosyncratic ownership effects for an individual firm would then be captured by the inclusion in the specification of firm specific dummies. Under this assumption, separating the full sample into sub-samples and carrying out the analysis for each of them separately, solves the endogeneity of ownership issue and provides consistent estimates. Adopting this approach, for the purposes of the analysis the sample is divided into the following five sub-samples: state owned, foreign owned, domestic outsider owned, employee owned and manager owned firms (*see endnote 15*).

GMM and Olley-Pakes (OP) regression estimates for the Cobb-Douglas, Constant Elasticity of Substitution and Translog production functions for each ownership group are reported in Table 4, Table 5 and Table 6, respectively (*see endnote 16*). These methods allow to explicitly control for the potential endogeneity of inputs as well as to model sample selection, which is an important factor given the potential exit from the market of least efficient firms. The presence of increasing (decreasing) returns to scale is given by significantly positive (negative) coefficient a_4 in the Cobb-Douglas case, significantly positive (negative) coefficient a_3 in the Constant Elasticity of Substitution case and significantly greater (smaller) than unity coefficient a_5 in the Translog case.

Focusing on the differences across estimation methods, we see that GMM estimates are generally insignificant although the regression fit in terms of the partial R^2 , which measures instrument relevance, is within the range of that found in other studies. Furthermore, instrument validity, tested through Hansen's J-statistic, is never rejected. However, as already noted, the insignificance of individual coefficient estimates could be driven by the fact that instruments are weak and their explanatory power is low. The OP results although producing the same general pattern of returns to scale, show more

significant evidence of the presence of increasing or decreasing returns to scale.

Test results on the appropriate functional form for the production function are mixed. The significance of coefficient a_5 in the Constant Elasticity of Substitution regression leads to rejection of the Cobb-Douglas as the appropriate functional form for domestic outsider and state owned firms. For all other firm types the Cobb-Douglas specification is firmly accepted. When the Translog specification is then compared to both the Cobb-Douglas and the Constant Elasticity of Substitution using F tests, it emerges that it dominates the other two functional forms only for domestic outsider owned firms. For employee owned firms the Cobb-Douglas form outperforms the other two, while for the other groups there is no one single form that dominates the other two across all estimation methods used. These conclusions indicate that pooling all firms in one sample and carrying out the estimation adopting one functional form, appropriately chosen, would result in misspecification bias.

The results, in general, provide support to our hypotheses. In the Cobb-Douglas and Constant Elasticity of Substitution case the coefficient of returns to scale is mostly positive and significant for employee and manager owned firms, pointing to increasing returns to scale, and mostly negative and significant across other ownership groups, pointing to decreasing returns to scale. The same pattern holds in the Translog case where the coefficient of returns to scale is significantly above unity for employee and manager owned firms, pointing to increasing returns to scale, and significantly below unity, for other ownership groups, pointing to decreasing returns to scale. Tests performed indicate that for domestic outsider and state owned firms the coefficient is significantly smaller than one, while for foreign owned firms it is not, suggesting that foreign owned firms operate at the constant returns to scale point of their production function.

Examining the results more closely we observe that coefficient signs are, generally, not affected by the functional form adopted. Their magnitude and significance, however, do, although differences in coefficients from one functional form to the other are not large. It would be desirable, however, to test whether this difference is significant or it is due to differences in other parameters. Yet, such tests cannot be performed through first estimating separate regressions and then comparing parameters across them, due to the fact that the covariance of the parameters to be compared cannot be estimated. One has to pool the data into a single regression where both coefficients appear, with dummy variables, and their interactions with all other variables in the regression, introduced to capture group specific coefficients. The estimation of a single regression is further complicated by two considerations. First, one has to account for the endogeneity of ownership

dummies. Second, estimating a single production function across groups of firms that have different functional forms might cause mis-specification bias. Nevertheless, bearing these points in mind when evaluating the test results, we proceed by pooling the data, estimating a single regression using all functional forms (*see endnote 17*) and then test for coefficient equality across ownership groups.

In general, the results of the tests are inconclusive, with the outcome depending on the functional form assumed and the estimation method applied. For instance, if returns to scale for manager and foreign owned firms are compared, the null of coefficient equality cannot be rejected when Constant Elasticity of Substitution and Translog production function parameters are estimated using GMM. However, returns to scale are significantly lower for manager owned firms when estimation is carried out using OP estimator. Similar conclusions are obtained when returns to scale parameters for foreign, manager, state and domestic outsider owned firms are compared to each other in pairs. Only, for employee owned firms are we able to show that they display significantly different returns to scale than all other groups across all functional forms and estimation methods.

Besides returns to scale parameters, an interesting fact that emerges from the tables is the high rates of growth of real output per annum across all ownership groups expressed by time trend coefficients α_2 in respective regressions. Curiously, none of the time trend coefficients is significant for the Translog production function. When the other two forms are adopted, we find that output growth rates range from 4,7% per annum for employee owned firm to 19,8% per annum for foreign owned firms. These estimates are large, even if one takes into account the high growth rates that Estonia's economy experienced over the period covered by this study. In fact, the average growth rate of real GDP in Estonia over the period 1995 through 1999 was around 4,7% per annum. Our results indicate average growth rates of about twice as large (*see endnote 18*), suggesting that our sample consists mainly of above average performing firms.

Another finding emerging from the tables is that the industry output variable is mostly insignificant. In particular, the expectation that its inclusion will correct the bias in returns to scale coefficients and consistently produce larger estimates is not fulfilled (*see endnote 19*). Sometimes returns to scale coefficients become larger, but sometimes they become smaller. The differences in absolute value across ownership groups are not small and the results are in line with those obtained before. Similarly, the estimates of the growth rates of real output confirm previous findings, with employee owned firms experiencing an average 4,8% growth per annum, while foreign owned firms experiencing an average 11,4% growth rate per annum.

The results of this analysis indicate that all firms in Estonia operate, albeit to a different degree, with inefficient input combination, i.e., they are at the wrong point on their production function. One potential explanation of this inefficiency is that it arises from conflicts with outside providers of capital or from preferences in capital allocation of various owners' types. Alternatively, the results could be driven from agency conflicts within the firms, i.e., from conflicts between owners and managers. If this were the case, the findings would be consistent with some theoretical predictions and empirical observations. First, foreign owners are more successful in disciplining management. Second, managers in domestic non-insider owned firms enjoy large degrees of discretion and they can pass the cost of their actions to other shareholders. Third, managers in employee owned firms enjoy high degrees of control and subsequently discretion. Yet, while agency conflicts might be present and play their role in inefficiencies in capital allocation, there is one environmental factor related to transition in general which explains the findings above. It is the fact that, most of the firms may have inherited capital from the pre-transition period that they do not need and that they cannot dispose of due to the lack of a secondary market. It could well be the case that one of the strings attached to privatisation contracts was that new owners, irrespective of their identity, were forced to buy the privatised entity as a whole instead of being able to cherry-pick the best assets and renounce the unproductive ones. To be able to conclude whether our results are mostly driven from one or the other explanation, we would need to control for the inheritance phenomenon.

6. Conclusions

This paper has analysed the effect of ownership structures on capital allocation by estimating returns to scale in a production function framework. The robustness of results has been tested through the use of alternative functional forms of the production function, namely Cobb-Douglas, Constant Elasticity of Substitution and Translog production functions. The theoretical arguments explored led to testable hypotheses regarding the effects of ownership structures on the efficiency of capital allocation. More specifically, employee and manager owned firms might display under-investment due to extra premium on the price of external finance charged by providers of capital because of idiosyncratic informational asymmetries and agency costs. Furthermore, over-investment might arise in firms with imperfect monitoring mechanism that lead to high degrees of discretion on the part of managers. In both cases firms will operate with inefficient input mix or inefficient scale, but the direction of the inefficiency will be different. In the case of under-investment the firm will display increasing returns to scale, while in the case of

over-investment it will display decreasing returns to scale.

The estimation of returns to scale suffers from simultaneity bias and endogeneity problems, which, if unaccounted for, lead to inconsistent parameter estimates and imprecise inferences. Simultaneity bias arises when right-hand side variables are correlated with unobserved factors that are relegated in the error term. Different estimators are developed to correct for this bias depending on the assumptions on the nature of unobservables and the way their effect is transmitted to right-hand side variables. Furthermore, the choice of input quantities is correlated with output prices present in the left-hand side variable when deflated sales or value added is used instead of real output. Finally, in the estimation of production functions one has to control for the endogeneity of ownership, i.e., the fact that, in equilibrium, different owners will determine their optimal ownership share based on various firm characteristics, among which is firm productivity. Here all these issues are explicitly accounted for, first by separating the sample into five sub-samples according to ownership structure and then carrying out the estimation for each sub-sample by employing alternative estimation methods. Moreover, the inclusion of total industry output as right hand side variable controls for the unobserved output price.

The results of this analysis indicate that, on average, all firms in Estonia operate, albeit to a different degree, with inefficient input combination, i.e., they are at the wrong point on their production function. One potential explanation of this inefficiency is that, it does not arise from conflicts with outside providers of capital or from preferences in capital allocation, but from agency conflicts within the firms, i.e., from conflicts between owners and managers. Yet, while agency conflicts might be present and play their role in inefficiencies in capital allocation, there is one environmental factor related to transition process in general which explains the findings above. It is the fact that, most of the firms may have inherited capital from the pre-transition period that they do not need and for which there is no a secondary market to dispose of. To be able to conclude whether our results are driven from one or the other explanation, we need to control for the inheritance phenomenon.

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Notes

¹ Insider owned are those firms where the ultimate decision-making rights and residual claims rest with their worker members, where the decision-making and residual claimant group could consist of the whole firm's labor force or a small part of it. From this set of firms are excluded those where employees exercise influence in decision-making through unions or other collective bargaining agreements.

² The traditional analysis of employee ownership assumes that employee owned firms are characterized by collective ownership and non-transferable individual rights. An important development in transition economies is that, in most of the cases, employee owners are share owners, i.e., they own part of the firm on an individual basis and are able to trade shares in the capital markets. However, these firms still retain a strong degree of collective ownership by imposing limits on share trade. Evidence of this is provided by, for instance, Kalmi (2002) for Estonia. In a field survey of firms under insider ownership he reports that in only 6% of his sample there are no restrictions on share trading. Furthermore, in 92% of the cases insiders are asked to offer their shares first to current shareholders.

³ The models on which these conclusions are based start from zero managerial ownership and then consider the dynamics once managerial ownership increases. However, the definition of low and high managerial ownership should not be taken as meaning majority (dominant) versus minority managerial ownership. High managerial ownership could be considered a stake as high as 10%.

⁴ In contrast to standard managerial theories, the term growth-oriented in this context does mean empire-builder for personal satisfaction but rather people devoted to restructuring and reform.

⁵ Financing of an MBO often requires external financing and only qualified managers might be able to raise external finance.

⁶ As Shleifer and Vishny (1997) point out state ownership can be viewed as a relation between a principal and two agents. The principal are the individuals (citizens), who are the ultimate owners of the firm. Being dispersed they have no ability and resources to monitor the state, i.e., the politicians and bureaucrats, who act as the first agent and who in themselves have to monitor managers, the second agent. Both agents have usually objectives quite different from those of the principals and they can easily collude to pursue their objectives at the expense of the principals.

⁷ This argument will not apply to foreign firms, as they are expected to have access to sources of funds other than domestic capital markets.

⁸ In what follows, in order to simplify the notation the firm index is suppressed, but it should be kept in mind that all variables refer to firm level ones.

⁹ In empirical work the translog production function framework has been widely used to examine various issues, such as, for instance, input substitution, separability and aggregation, technical change, productivity growth and productive efficiency. However, in most of the studies, estimation is carried out using cost share equations derived under the assumptions of constant returns to scale and perfect competition in both input and output markets.

¹⁰ The source of this bias is the unobserved firm characteristics that affect input choices. A more formal and detailed presentation of this issue, as well as a summary of studies that account for it, can be found in Griliches and Mairesse (1995).

¹¹ They specify the demand facing an individual firm as a function of total demand faced by the industry and the market share of the firm. The omitted output price variable is then expressed as a function of observables, such as industry's and firm's output. Incorporating this relation in the production function specification leads to the addition of industry's output as a right-hand side variable with its coefficient being the inverse of firm's demand elasticity. Their empirical results show that the coefficient of the industry's output is highly significant and that its inclusion eliminates the downward bias in scale elasticities.

¹² The criteria are: (i) The firm's capital at the beginning and the end of the period should be positive; (ii) Investment should be non-negative; (iii) Investment should be smaller than end of period capital stock; (iv) Sales should be positive; (v) The average employment per year should be positive and equal or greater than 10 ; (vi) Labor cost in a given year should be positive ; (vii) Ownership shares should add up to 100.

¹³ Ownership is defined as the right to residual returns, i.e., to what remains after the factors of production have been paid their contribution. In addition, some authors, as for example Hansmann (1996), argue that control rights should also be included in the definition of ownership. This, however, brings up the issue, stressed, for instance, by Aghion and Tirole (1997), whether formal or real control need to be taken into account. For example, Kalmi (2002) presents case study evidence that in employee owned firms there are the managers those who exercise real control. Measuring control, however, and, especially, distinguishing formal versus real control, would require data, for instance, on owners' board representation, on voting rules, shares classes and voting behavior of different groups of owners, which are not available. Bearing this in mind, for the purposes of this analysis ownership is defined in terms of the percentage of shares held by each group of owners.

¹⁴ Another solution would be the application of Maximum Likelihood Estimation. Yet, this approach is more sensitive to misspecification and is more data intensive.

¹⁵ With respect to former employee owned firms the total number of observations over the whole sample is small and, given that estimation methods are data intensive, it does not allow meaningful analysis. One approach to carry out the analysis is to group these firms together with employee owned firms. While it is difficult to imagine that former employee owned firms will behave similarly to real outsider owned firms, it might also be debatable whether they will display behavior similar to employee owned ones. An argument in support of this assumption is that, drawing from their previous experience as insiders

in the firm and potentially enjoying high degrees of coordination with their previous peers, i.e., current incumbents, former employees will actively participate in monitoring the management as well as be involved in important decision-making. If this argument does not hold, however, former employee owned firms will be closer to state owned firms where managers enjoy high degrees of discretion in following their objectives at the expense of outside shareholders. Tests were performed to determine whether former employee owned and employee owned firms could be pooled together. In no case were we able to reject the null hypothesis that coefficient vectors are the same across both groups. Subsequently, we pool these two groups together in the analysis.

¹⁶ In unreported regressions depending on different assumptions on the degree of simultaneity bias and endogeneity of inputs, we also estimated specifications using OLS, Within in levels, OLS in first differences, Within in first differences. The findings based on these estimates are essentially unaltered from those reported in Tables 4, 5 and 6. These unreported regressions are available from the authors upon request.

¹⁷ Ownership dummies are instrumented with the fitted values of a first-stage probit equation predicting the probability that a firm would be in a given ownership structure at a particular point in time as function of firm's profitability, productivity, capital intensity, labor quality, investment, all lagged one period, as well as firm size, industry and time specific effects. In estimation the variance of the residuals is not constrained to be the same across groups.

¹⁸ We obtain the same results when the sample is pooled and a single equation is estimated. In this case the estimates of time trend parameter are the following: 0.092 for the Cobb Douglass, 0.084 for the Constant Elasticity of Substitution and 0.118 for the Translog production function. The latter coefficient is, however, insignificant.

¹⁹ We estimated regressions, unreported here, excluding the industry output variable. The results were similar in terms of sign and significance, but there were substantial changes in magnitude.

STRUCTURES OF OWNERSHIP AND CONTROL IN SPANISH FIRMS BETWEEN 1997 AND 2006

*Olga Del Orden**, *Aitor Garmendia***

Abstract

When approaching the study of how financial systems carry out their role in the control of the good governance of enterprises, many articles of research have centred on the analysis of the ownership structure of these firms. Attempts have been made to see if differences exist, in the nature and degree of concentration of ownership, in the level of pressure and control exercised over the managers and the repercussion of all this on the manner of managing the business. The intention of our research article is to shed light on the development of the structures of ownership and control in Spanish enterprises between 1997 and 2006, and their possible influence on the results of these enterprises.

Keywords: Corporate Governance, Ownership Structure, Spain

* *Ph.D., Associate Professor*

e-mail: oorden@ud-ss.deusto.es

** *Ph.D., Assistant Professor*

e-mail: agarmend@ud-ss.deusto.es

Both: Deusto University, E.S.T.E., Business School, Pº Mundaiz 50, 20012 San Sebastián, Spain

Tel: 00 34 943 326 309, Fax: 00 34 943 273 089

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1. Introduction

One of the most important concerns of economists throughout the ages has been the process of economic growth, its sources, and the policies which support it. In the traditional approach to this topic, although the variables concerned and the perspectives of analysis adopted are both numerous and very different, on very few occasions has economic growth been linked to the development of the financial system. Just as Pampillón (2000) points out, Schumpeter, for example, underlines the role played by the financial system in the expansion of technological innovation, and Bagehot analyses its influence on the industrialisation of England.

However, in the last few years the panorama has changed notably. The financial system, its configuration and degree of development, have changed from playing a secondary role to being key factors for the economic growth of a country, and, as a consequence, they have been studied by a large number of economists (Mato, 1990 and 1993; Raimond, Maroto and Melle, 1999; Thakor, 1996; Schmidt and Tyrell, 1997; Sollow, 1998; and Pampillón, 2000, among others).

Considering the financial system as the grouping of mediating institutions, markets and active

financiers, all these authors agree that the financial system fulfills, at least, two basic functions.

- To channel savings towards investments with the expected highest profitability.
- To control the good governance in the administration of the enterprises' financial resources.

Referring to the first of these functions, one can expect that the financial system will obtain an effective and efficient distribution of the financial resources, bearing in mind the existing alternatives of investment and their possibilities of gaining profits. Maroto (1993), for example, highlights the fact that the financial system is the source of the financial resources which facilitate the development of the firms' activity and, at the same time, is the framework for the valuation of its equities and performance. In consequence, he concludes that the financial structure of the firm and the characteristics of the financial system in which the companies carry out their activity, cannot be separated.

Numerous studies (Rajan and Zingales, 1995; González, 1997; Mato, 1990; Morck, Nakuma and Shivdasani, 2000; Brailsford, Oliver and Pua, 2002; Salas, 2002; Tong and Ning, 2004; and Joeever, 2005; among others) have analysed the relationship between the financial structure of the firms, its cost, the degree of access to the different financial sources needed to carry out their investment projects and the results

obtained. These studies have also considered the influence of some significant variables such as size, age or the ownership structure of the firms analysed.

As far as the second of these functions is concerned, the financial system is obliged to exert control over the different economic agents that receive financial resources, in order to avoid an inefficient and imprudent management of these resources. In this way, if the main function of the financial system is the efficient assignment of the financial resources at a macroeconomic level, this second function emphasizes the need for the same financial system to watch over the adequate administration of the financial resources at microeconomic level.

The concern for this second function arises, above all, from the progressive separation between ownership and control of the firm, and of the consequent breaking of links between the interests of the firm's managers and the objective of maximizing the benefits sought after by the shareholders. An efficient financial system is that which manages to have the institutional and organisational mechanisms needed to resolve the possible conflicts of interest which could arise from the different agents which interact with the business (shareholders, managers, suppliers, commercial and financial creditors, etc.). Berle and Means (1932) were the first to analyse these topics and stressed the importance of the agency problems within the modern corporations. In the same sense, authors such as Salas (2002)²² underline the need to establish mechanisms to improve the transparency of company's information in order to facilitate the external control of the firm's managers.

In this field, many of the studies have focussed on analysis of the ownership structure of the firms, on the degree of pressure and control exerted over the managers according to the nature and degree of ownership concentration, and the influence of all this in the investment and financing decisions, and the firm's performance (Mato, 1990; Paterson, 2001; Salas, 2002; Walt, Ingle and Diack, 2002; Crespi and García, 2002; Evans, Evans and Loh, 2002; Jones and Danbolt, 2003; Alvar and Mendes, 2004; Bauer, Guenster and Otten, 2004, among others).

On analysing the existing relationship between the ownership structure of the firms and their performance, Shleifer and Vishny (1986), Leach and Leahy (1991), Prouse (1992), Maher and Anderson (1999), Welch (2003), and many other authors,

²² In this study, the author highlights the importance of good regulation in this respect and points out that the theory of agency allows us to understand the way in which asymmetrical information and the conflict of interests between investors and managers could affect the production possibilities of the enterprise. In this way, he defines the costs of agency as the distance between the production possibilities that technology offers to the company and that which it achieves, given the existing restrictions on information.

associate a higher degree of ownership concentration with a greater possibility of monitoring managers and, in consequence, with a higher probability of obtaining a better performance.

Other authors, such as, Prouse (1992), Morck, Nakamura and Shivdanasi (2000), Cuervo, Fernández and Gómez (2002), Salas (2002), Douma, George and Kabir (2003), Morck and Yeung (2003), Tong and Ning (2004) among others, centre their attention on how the different types of majority shareholders (banks, individuals and families, non-financial corporations, foreign firms, etc.) influence over two fundamental aspects: 1) the way of managing the business and, in consequence, the results obtained; and 2) the different capability of monitoring managers according to the their ownership stakes. These authors underline the important role that banks and other credit firms can play supervising and monitoring firm's managers, given that they can carry out this function both in their role as shareholders and also as creditors of the firm. Besides, their presence as shareholders of a company may be a facilitating element to obtain additional financial resources. Douma, George and Kabir (2003) have detected a positive correlation between the presence of financial firms in the ownership of the firms and their results in the short term. At the same time, they have observed that the presence of other non-financial firms with a relevant block of shares normally has a long term effect and can play an important role in the supervision and control of the management.

Finally, it is worth pointing out that family businesses have also been the object of numerous pieces of research (Morck and Yeung, 2003) as a consequence of the importance of this type of firms in our business world. Within this field of research, in this work, we have focussed our attention on the analysis of the ownership structure of Spanish companies and, at the same time, its influence on their performance, differentiating the companies according to their activity sector and size. The data available has permitted us to offer a good picture to these topics for the years 1997, 2001, 2003 and 2006.

2. Objectives

The main objective of this study is to research and analyse the evolution of the ownership structures and control of Spanish enterprises between 1997 and 2006 and its influence on their performance. This general objective will be made more explicit in the following specific objectives:

- To analyse the ownership structure in Spanish firms and its evolution during the last decade.
- To study whether the different types of shareholders have different investment strategies, channelling their investments to companies of certain activity sectors or size.
- To analyse the nature of both the majority and the predominant shareholders in Spanish companies, and, at the same time, its evolution from 1997 to 2006.

- To analyse the relationship between the nature of the majority shareholder and the performance of the companies studied in 1997, 2001 and 2003.

3. Database: approach and coverage

To research the objectives of this study we have used the SABI database elaborated by Informa S.A - Bureau Van Dick. Nowadays, this database offers financial accounts and ownership information about a large number of Spanish firms that deposit this information in the Spanish Central Mercantile Register²³. All the limited companies and private limited companies have the obligation to deposit their financial accounts in this registry every year. Therefore, the database does not include the companies that have not the obligation to deposit their accounts there (for example, private individuals).

3.1 Approach and codification of the database

It has been necessary to codify all the shareholders information according to their nature. Although for the year 2006, the registers of shareholders are already codified by SABI, we have codified manually all the shareholders for 1997, 2001 and 2003. It is important to point out that we have centred our attention on those shareholders which offer details of the amount of their stakes, since this is an essential data for our present research. Besides, only the information about shareholders of companies which figure as “active” in the database has been codified. We have codified shareholders according to the next classification: Domestic banks and other credit firms; Individuals and families; Non-financial domestic firms; Foreign firms; State; Non-bank financial institutions; Others.

Once the registers of the shareholders have been codified, for each participating business, we have calculated the percentage of capital which is controlled by each of the seven types of shareholders identified. For each company we have created seven new fields in which we compile the details of the proportion of capital which is controlled by: 1. Domestic banks and other credit firms; 2. Individuals and families; 3. Non-financial domestic firms; 4. Foreign firms; 5. State; 6. Non-bank financial institutions; 7. Others.

²³ For further information please consult the RD 1784/1996 of 19th July which ratifies the Regulations of the Mercantile Register in the following sections: TITLE II OF THE INSCRIPTION OF THE BUSINESS DEALERS AND THEIR ACTIONS, CHAPTER I. GENERAL DISPOSITIONS. Article 81. Subjects and actions which are obliged to be registered. CHAPTER III. OF THE DEPOSITING AND PUBLICATION OF THE ANNUAL ACCOUNTS. SECTION I.OF THE PRESENTATION AND DEPOSITING OF THE ANNUAL ACCOUNTS. Article 365. Obligations of the presentation of annual accounts.

A new variable has also been created for each company which we have denominated as “Type of predominance”. With this variable we have classified the firms according to the predominant type of shareholder in their ownership structure. We have considered that a type of shareholder is predominant when it controls more than 50% of total equity. It is important to underline that behind the percentage of capital that a specific type of shareholder controls, there may exist several stakes of different shareholders of the same nature. For example, in a company where individuals and families are the predominant shareholders, it is possible that there exist different shareholders, all of them classified as individuals and families, that together as a whole control more than 50% of total equity of the firm.

To codify this variable, to the seven previous codes we have added the following:

- Two types of shareholders own 50% of the total equities each.
- None controls 50% of the total equities .
- There are no available data.

We have also classified the firms according to the nature of the majority shareholder who controls more than 50% of the total equities, since this indicates that this particular shareholder controls the company.

On the other hand, the enterprises with shareholders information have been classified according to the number of employees, distinguishing the following levels of employment:

- Between 1 and 9 employees.
- Between 10 and 19 employees.
- Between 20 and 49 employees.
- Between 50 and 249 employees.
- Between 250 and 999 employees.
- More than 999 employees.

For those enterprises which have not offered the data of their number of employees in the register corresponding to the enterprise, we have attempted to complete this data by checking their financial accounts which also contain this information. To carry out this consultation, we began by the financial accounts nearest in time in order to obtain the most up-to-date data possible. Despite this, in one group of important enterprises, it has not been possible to find out the number of employees.

Before beginning the process of calculating the performance ratios, it has been necessary to prepare the data of financial accounts which the database SABI offers. Of the various options which the database offers, we have made use of the financial accounts of the simplified model since it is the model which offers the best coverage of data. Although the normal or mixed models of financial accounts offer a greater detail of the different sections of the balance sheet and the profit and loss account, they contain data of a considerably lesser number of firms than those which offer data in the simplified model.

In the same way, it has been necessary to unify the monetary units in which the financial accounts of

the different years have been expressed, since, for example, in the database of 1997 the figures are expressed in millions of pesetas, in the year 2003 in thousands of euros and in 2006 in euros.

After the preparation of the database, we have also calculated the following performance ratios for the different years:

- Return on Assets (R.O.A.) = *Earnings before interests and taxes/ Total assets*
- Return on Equity (R.O.E.) = *Net income/ Equity*

After calculating these ratios, we have excluded of our performance analyses all the firms with negative equity in order to avoid atypical values of ROE. In addition, we have excluded the firms that showed extreme values in ROA and ROE ratios (we have excluded all the firms where ROA and ROE values are more than two standard deviations away from their average value).

3.2 Coverage of the data and profile of the firms

Table 1. Coverage of the SABI database

	1997	2001	2003	2006
Number of firms included in SABI	182.667	194.076	577.239	939.757
Number of firms included in DIRCE (excluding individuals)	n.a.	994.052	1.118.616	1.383.267
Coverage	n.a.	19,5%	51,6%	67,9%

Now, we offer the profile of the firms, contained in SABI, that we are going to analyse in our research (we will indicate in each case, and in brackets, the tables in the annexe which contain the data we are presenting).

• **Legal status** (see Annexe Table 1). In 2006, 85,4% of the existing companies were limited companies, whilst the public limited companies represent 13,3% of the total. On the other hand, the proportion of firms which have other legal status (cooperatives, associations, etc.) is most reduced (1,3%). It is noteworthy that the prominence of public limited companies has decreased between 1997 and 2006, whilst parallel to this the importance of limited companies has increased over the same period.

• **Size** (Table 2). Size is one data which is not always provided by the business. In fact, in 1997 almost half of the firms had not released this information, whilst in 2006 this number went down to 14%. For this reason, at the moment of studying this characteristic, instead of basing ourselves on the percentages calculated over the total of the businesses present in each year's database, we will base our work on the calculations concerning the businesses which have given information about their employee numbers. With this in mind, in 2006, the firms with less than 10 employees represented 77,3% of the Spanish enterprises who furnished us with the data concerning size, whilst the enterprises with between 10 and 19 employees represented 12,2%, which indicates that the remaining 10,5% are businesses with more than 20 employees. The importance of the group made up of the smaller sized companies (1-9

employees) has grown yearly whilst that of the rest of the groups has suffered a slow decrease. The explanation for this evolution could be found both in the fact that the number of firms of a smaller size, in relative terms, has increased, and the number of small firms which deposit their accounts in the Mercantile Register has also increased. In our opinion, this could also be due to the incorporation of a higher number of smaller sized firms in the SABI database when this amplified its capacity in an important way on passing from CD support to DVD with the larger possibilities of storage that this implies. 2001 appears as a peculiar year since the percentage of smaller sized firms was reduced in an important way and the firms of other size took on a greater prominence. The explanation for this could be that 2001 was for SABI a transition year in which they were preparing to pass from CD to DVD and the inclusion in the database of the larger firms took first priority.

• **Activity Sector** (Table 3). In 2006 the great relevance of the service sector stands out from the others. The enterprises dedicated to commerce, repairs and other services represent almost 70% of the total. On analysing the evolution over the last decade, our attention was drawn to the relative greater presence of firms of the primary sector, and at the same time, that the percentage of industrial businesses declined notably yet in construction there was a slight upward move. The relative importance of "Commerce and repairs" firms, after a certain growth between 1997 and 2001, experienced a clear decline between 2003 and 2006 which contrasts with the important increase of the businesses in the "Other services" sector due,

above all, to the increase of companies dedicated to estate agency and renting activities, and also, to services rendered to other companies. To conclude, we can say that the average profile of the firms analysed in 2006 corresponds to that of a limited company, whose activity is carried out in the service sector and which has between 1 and 9 employees. This profile is very similar to the average firm in 1997, except for the fact that, then, the difference between the proportion of limited companies and public limited companies was smaller and, at the same time, we had a minor difference between the percentage of industrial sector and the service sector firms.

4. Ownership and control structures (1997-2006)

This section is organized according to the proposed objectives. In the first part we analyse Spanish firms ownership structure. In the second part we deep on the study trying to discover the investment preferences of the different types of shareholders, taking into account the activity sector and the size of the participated firms. In the third part we analyse the relevance of each type of shareholder from a double perspective: first, taking into account, the nature of majority shareholder (who controls more than 50% of equity); and, second, considering the nature of the predominant type of shareholder (once shares have been grouped for each type of shareholders). Finally, in the fourth part, we focus on the relationship between the nature of the majority shareholder and the firm's performance, in order to determine whether the nature of owners has a negative or positive effect on the results achieved by the company.

4.1 Description of ownership structure

In this section we focus on the study of ownership structure from a global perspective, according to the following aspects:

- The number of firms participated by each type of shareholder and the percentage over all firms.
- The average and standard deviation of share stakes of each type of shareholder in firms.
- The average participation on equity owned by each type of shareholder.

4.1.1 Number of firms participated

Figure 1 (Table 4 of the annexe²⁴) shows that individuals and families are the most frequent type of shareholder in our firms. In 2006 they are present in the ownership structure of more than 72% of Spanish

firms. The second position is for non-financial domestic firms which participate in 21,2% of firms, followed by foreign firms (3,9%) and non-bank financial institutions (1,3%).

In addition, we observe that there have been slight variations in the ownership structure of firms from 1997 to 2006, although it has not changed the relative importance of each type of shareholders in this period. On one hand, the participation of individuals and families has gone down slightly (from 73,6% to 72,1%). In the same way, the proportion of firms participated by foreign firms (from 4,4% to 3,9%), banks (from 1% to 0,7%), state (from 0,6% to 0,5%) and non-bank financial institutions (from 1,6% to 1,3%) has declined slightly. On the other hand, there has been a noticeable increase in the proportion of firms participated by other non-financial Spanish firms (from 18,7% in 1997 to 21,2% in 2006).

4.1.2 Average share stake

Figure 2 (Table 5 of the annexe) shows that the average share stake of all types of shareholders is high (as much as the standard deviation related to this average) and that it has increased from 1997 to 2006.

However, we observe different patterns among the different types of shareholders. In 2006, foreign firms show the largest average stake (78,4%), followed by non-financial domestic firms (61,4%), state (54,4%) and individuals and families (50,6%). The remaining types of shareholders have average share stakes of less than 50% -non-bank financial institutions (45,5%), banks (43,6%) and "others" (32,6%)-. In all cases, except for the group "others", it is observed an increase in the average share stake between 1997 and 2006. It will be interesting to contrast these data with that relative to majority shareholders and predominant type of shareholders, in order to determine whether these percentages mean a larger concentration of power, and, in consequence, control over the managers in Spanish firms.

4.1.3 Percentage of total equities owned

If we analyse the proportion of total equities controlled by the different types of shareholders in the Spanish firms, Figure 3 (Table 6) shows that in 2006 almost 50% is owned by other non-financial Spanish firms, 20% by foreign firms and 17% is owned by individuals and families. The other types of shareholders (non-bank financial institutions, banks, state and others) own the remaining 14% of total equity. Between 1997 and 2006, without taking into account the atypical variations observed between 1997 and 2001, stands out the growth of the proportion of equity held by nonfinancial domestic firms (from 46,8% to 48,1%), non-bank financial institutions (from 3,4% to 6,9%) and individuals and families (from 15,8% to 16,8%). On the other hand, there has been a decrease in the proportion of equity owned by banks (from 6,9% to 4,4%) and state (from 5,9% to 3,1%).

²⁴ The analysis of data included on Table 4 has to consider that firms are owned by different types of shareholders, and due to that, the total number of firms does not match with the figures compiled in each of the columns.

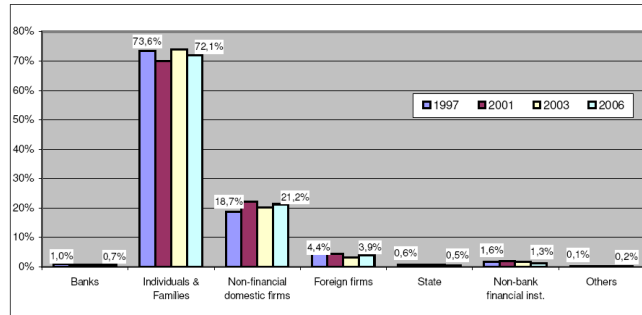


Figure 1. Percentage of firms participated by each type of shareholder

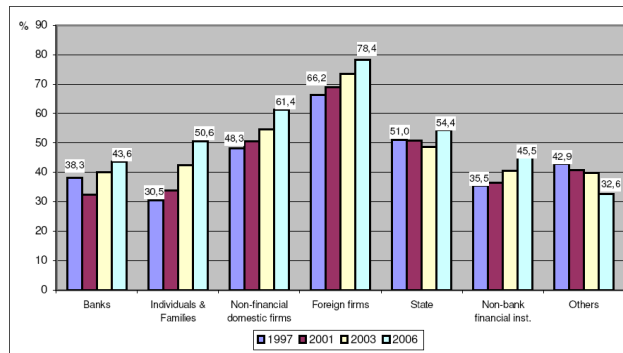


Figure 2. Average share stake of each type of shareholder

Finally, the percentage of total equity controlled by foreign firms has hardly changed between 1997 and 2006 (from 20,6% to 20,4%).

In summary, if we would have to underline the main key features of the ownership structure of the sample of Spanish firms analysed we would say that in 2006:

- Foreign firms own 20,4% of the total equity of Spanish firms, concentrate their participations in a small number of firms (3,9%), and hold very large stakes in these firms (78,3% on average).
- Non-financial Spanish firms own 48,1% of total equity, on average hold quite large share stakes (61,4%), and take part in the ownership of 21,2% of the firms.

- Individuals and families are present in a very large proportion of firms (72,1%), although their average stake (50,6%) is lower than that hold by the two previous shareholders. Besides, they only own the 16,8% of total equity, and consequently it seems that they hold their participations especially in small firms.

- Finally, the presence of non-bank financial institutions, banks and state in the ownership structure of Spanish firms is scarce. They participate as shareholders in 2,6% of the analysed firms, their average stake is between 43% and 50%, and they own the 14,4% of total equity. Therefore, it seems that they hold their stakes especially in large sized firms.

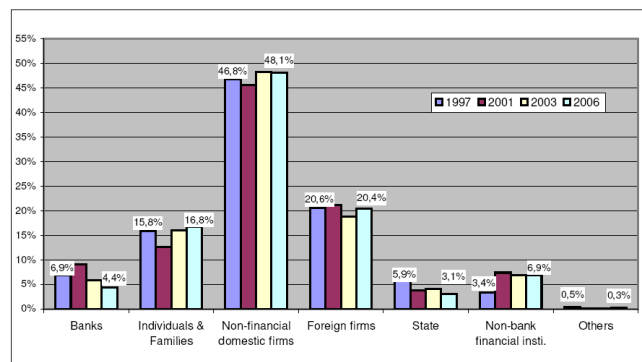


Figure 3. Proportion of total equities owned by each type of shareholder

4.2 Ownership structure and sectors

In this section we focus on the degree of attraction of each sector for the different types of shareholders and the differences among them. To achieve our aim, we have calculated a sector bias-index to show the investment tendency of the different types of shareholders on each sector for 1997 and 2006 (Table 7 and Figures 4 and 5).

Algebraically this sector bias-index has been defined as follows:

$$\text{Sector bias-index} = \frac{x_i / X_T}{y_i / Y_T}$$

where:

- x_i denotes the equity owned by the type of shareholder X in i-sector companies.
- X_T denotes the total equities owned by the type of shareholder X.
- y_i represents the total equities invested in i-sector companies.
- Y_T represents the total equities invested in all sectors companies.

When this ratio is larger than one it means that the type of shareholder under analysis is investing in the considered sector a proportion of resources superior to the importance of that sector in the global portfolio of firms. In contrast, if this ratio is below one it means that the weight of this specific sector in the shareholder's portfolio is below this sector's weight in total firms' portfolio.

The analysis of this ratio shows that:

- Non-financial domestic firms are close to the average in almost all sectors, even though we detect a greater interest for the construction sector and a lesser interest for that of commerce and repairs. In 1997 the situation was similar, but, at that moment, the industry sector stood out as positive and the primary sector negative.

-Commerce and repairs, and industry are the two sectors in which foreign firms are specially interested in 2006. Their investment in the primary sector and in construction is quite a lot less than the average. Their situation in 2006 is fairly similar to that of 1997.

-Individuals and families stand out because of their interest in the primary sector and the construction sectors, especially the first, hardly considered by the rest of shareholders. Commerce and repairs firms attract them in an important way. The picture of 1997 is very similar to that of 2006 except for the growth of their importance in the primary sector.

-The primary sector has been the great loser in the investment portfolio of non-bank financial institutions. Whereas in 1997 was a clear option for this sector, in 2006 what stands out is their lack of interest in it as in the rest of sectors with the exception of "other services".

-In 2006, banks focus clearly on firms whose activity is "other services", showing in the rest of sectors an interest smaller than the average. In 1997, the construction sector was one of their strongest options.

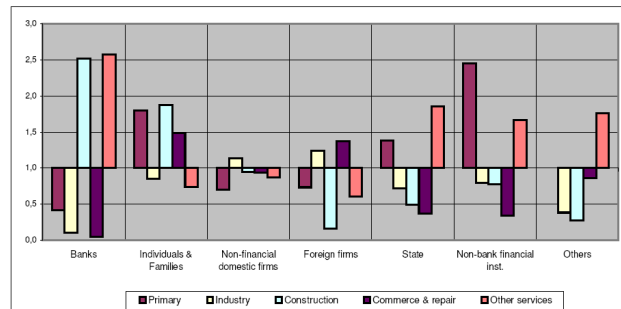


Figure 4. Shareholders' portfolio sector bias-index, 1997

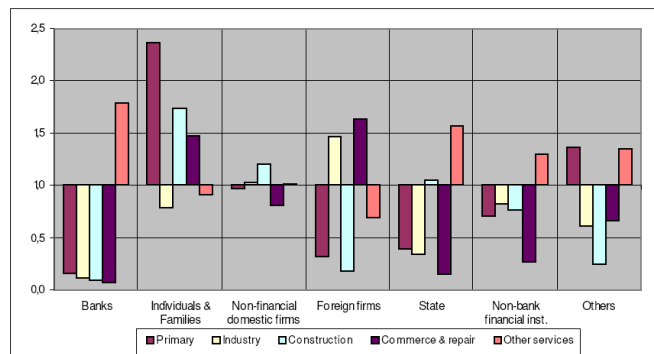


Figure 5. Shareholders' portfolio sector bias-index, 2006

-Similarly to non-bank financial institutions, in the analysed period, the state investments portfolio has underweighted primary sector, industry and commerce and repairs companies. Simultaneously, construction companies have been overweighted in this portfolio.

4.3 Ownership structure and firm's size

In this section we study the relationship between the firm's size and their ownership structure, in order to detect the investment preferences of the different types of shareholders.

Following the same idea of the previous section, we have defined a new size bias-index to show the investment strategy of the different types of shareholders on each firm's size range for 1997 and 2006 (Table 8 and Figures 6 and 7). Algebraically this size bias-index has been defined as follows:

$$\text{Size bias-index} = \frac{x_i / X_T}{y_i / Y_T}$$

where:

- x_i denotes the equity owned by the type of shareholder X in i-size range companies.
- X_T denotes the total amount of equity owned by the type of shareholder X.
- y_i represents the total equities invested in i-size range companies.
- Y_T represents the total equities invested in all sectors companies.

When this ratio is larger than one it means that the type of shareholder under analysis is investing in the considered firm's size range a proportion of resources superior to the importance of that size range in the global portfolio of firms. In contrast, if this ratio is below one it means that shareholders underweight this specific firm's size range in their portfolio.

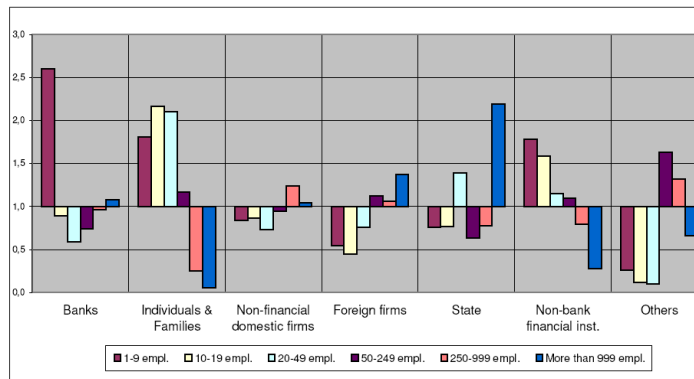


Figure 6. Shareholders' portfolio size bias-index, 1997

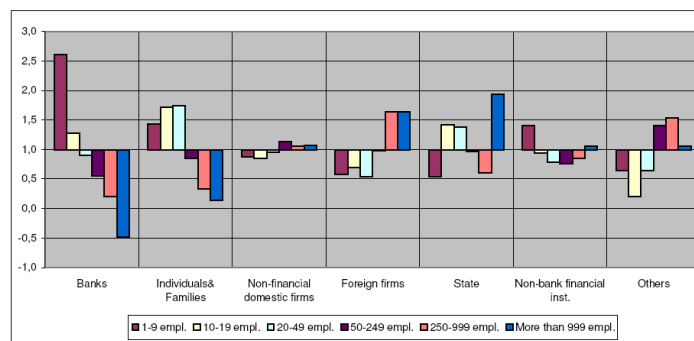


Figure 7. Shareholders' portfolio size bias-index, 2006

Furthermore, it is important to notice that some firms do not provide information about the number of employees. Consequently, we have decided to focus exclusively on those firms who offer the employment data, that is, 51,9% of all the firms analysed in 1997 (67,19% of total equity) and 85,8% in 2006 (92,90% of total equity).

The analysis of these data leads us to the following conclusions about the relationship existing

among the ownership structure of Spanish firms and their size:

-Especially in 2006, the investments of non-financial domestic firms are shared out among companies of different sizes according to the weight of each size ranges in the economy. However, we observe a slight tendency to overweight the largest firms in their investment portfolios, although this tendency softens up in 2006.

-Foreign companies show a clear preference for the medium-large sized firms and underweight the smaller firms. Besides, their interest in large companies has grown up from 1997 to 2006.

-Individuals and families overweight small firms and underweight medium and large firms in their investment portfolio. However, they have significantly balanced their investment portfolio between 1997 and 2006.

-Although in 1997 non-bank financial institutions focus their share holdings especially in small-medium sized firms, in 2006 they show a more balanced investment portfolio. Nonetheless, they maintain their preference for small firms.

-In the time period analysed, banks maintain a clear preference for small sized companies. It is important to highlight that, between 1997 and 2006, banks underweight significantly their share holdings in large corporations (those with more than 999 employees).

-The pattern of the state share holdings is difficult to define. We observe a clear preference for large sized companies, especially in 1997, and less interest in small firms.

4.4 The control of Spanish firms

In order to know who is behind the control of Spanish firms, we have analysed the following two aspects:

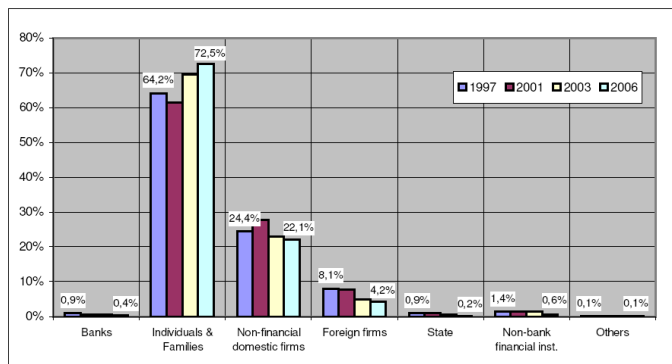


Figure 8. Proportion of firms where predominates each type of shareholder

If we analyse the average number of shareholders that hold each type of predominant position (Figure 9) we observe that in 2006 it varies from 1,28 in companies where foreign firms and non-bank financial institutions are the predominant shareholders to 1,86 in companies where individuals and families are the predominant block holders. Although considering all the companies as a whole, the average number of predominant shareholders has decreased from 1,62 in 1997 to 1,22 in 2006, there have been different evolutions depending on the nature of the predominant shareholder. The decrease from 3 to 1,86 in the average number of different individuals and families needed to give them predominance in one company is the most significant variation from 1997

-The nature of the predominant type of shareholder. We have considered that a type of shareholder is predominant in a company when it controls more than 50% of its total equity. Besides, we have computed the average number of shareholders involved behind each type of predominant shareholder (Table 9 of the annex) and have analysed the proportion of firms in which a specific type of shareholder is predominant in the set of companies he participates (Table 10 of the annex).

-The nature of the majority shareholder who owns more than 50% of total equity. (Table 11 of the annex).

4.4.1 The nature of the predominant type of shareholder

According to our data (Figure 8), in 2006 individuals and families are the predominant type of shareholder in 72,5% of the analysed Spanish firms. In second place, we observe that nonfinancial domestic firms are the predominant shareholders in 22,1% of firms and, far behind, foreign firms predominate in 4,2% of firms. Furthermore, little change is observed during the period analysed: an increase in the proportion of firms with a predominance of individuals and families in their ownership structure (from 64,2% in 1997 to 72,5% in 2006) and a decrease of this proportion in the rest of the cases.

to 2006. This shows that ownership concentration degree has grown up in this type of firms. However, the average number of different stakes maintained by the state in companies where he is the predominant shareholder, has grown up from 1,33 in 1997 to 1,84 in 2006. For the rest of the firms, this variation has been quite small. In order to analyse the frequency in which the different types of shareholders hold this predominant position when they participate in the ownership of firms, for each type of shareholder we have computed the proportion of firms in which this situation happens (Figure 10, Table 10).

According to this data, in 1997 individuals and families have, along with non-bank financial institutions and banks, the smallest percentages of

predominance among participated firms. On the other hand, when foreign firms hold their stakes in other companies they became the dominant type of shareholder in 63,7% of the participated firms. This proportion reduces to 50,7% and 45,4% when the shareholders are the state and non-financial domestic firms, respectively. This scene changes considerably in 2006. We notice an important growth (from 30,4% in 1997 to 48,2% in 2006) in the proportion of firms that, being participated by individuals and families, are dominated by this type of shareholder. The same happens with the proportion of firms where non-

financial domestic firms (varies from 45,4% in 1997 to 49,8% in 2006) or non-bank financial institutions (varies from 29,7% to 31,5%) play a predominant role. In contrast, in the same period the proportion of firms where, being shareholders, they hold a predominant position has decreased in the case of foreign firms (from 63,7% to 51,9%), state (from 50,7% to 46,7%) and banks (from 33,4% to 25%). So, dominance has displaced from foreign firms, banks and state towards, above all, individuals and families, who seem to have undergone an important ownership concentration process in the analysed period.

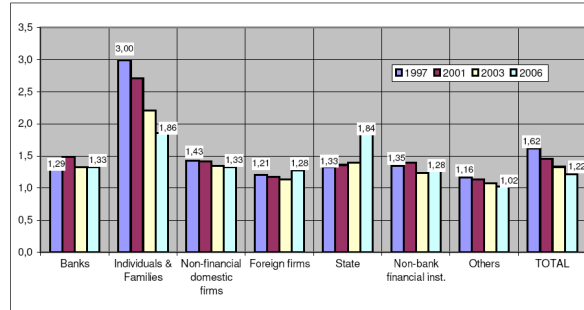


Figure 9. Average number of shareholders behind each type of predominance

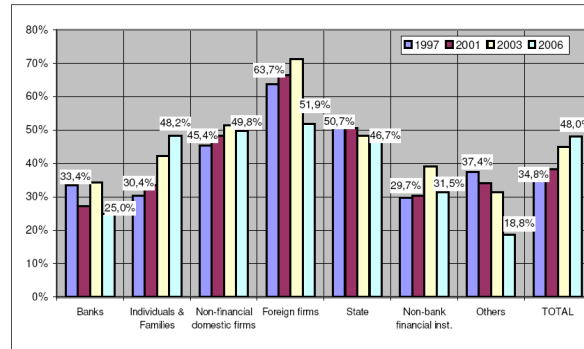


Figure 10. Proportion of participated firms where each type of shareholder is predominant

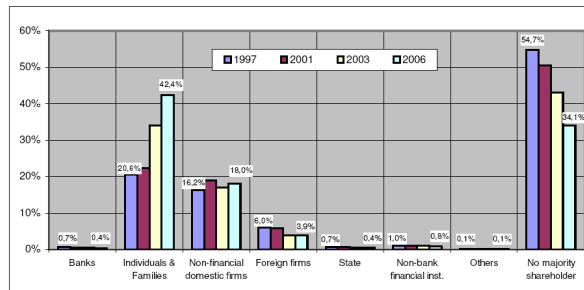


Figure 11. Nature of the majority shareholder

4.4.2 The nature of the majority shareholder

In this section we look deeper into the idea of control and focus on the analysis of those firms with a

majority shareholder who, owning more than 50% of total equity, can exert real control over the owned firm. Figure 11 (Table 11) shows the nature of the

majority shareholder in the analysed set of companies between 1997 and 2006.

From 1997 to 2006 we observe an important decrease in the proportion of firms without a majority shareholder (from 54,7% to 34,1%) and a significant increase in the proportion of firms controlled by individuals and families (from 20,6% to 42,4%). Furthermore, we notice a slight increase in the proportion of firms controlled by other non-financial domestic firms (from 16,2% to 18%) and a decrease in the percentage of firms controlled by foreign firms (from 6% to 3,9%). The proportion of firms controlled by the rest types of shareholders remains stable in the considered period. Therefore, we conclude that there has been an important concentration process in the ownership structures of the analysed Spanish firms between 1997 and 2006, increasing considerably the proportion of firms controlled by individuals and families. However, in 2006 more than one third of the firms do not have a majority shareholder.

4.5 Ownership structure and performance

In this section, we analyse the relationship between the ownership structure and performance of Spanish companies between 1997 and 2006. To do this, we have calculated the average ROA and ROE on firms grouped according to: 1) the nature of the predominant type of shareholders; and 2) the nature of the majority shareholder, for 1997, 2001 and 2003 (we still do not have the data for 2006), in order to study whether firm's ownership and control structures matter on their performance. The results we have obtained in these analysis have been quite similar (Tables 12 and 13). We have observed that there are no big differences, related to ROA and ROE, on firms grouped depending on the nature of either the predominant type of shareholders or the majority shareholder. For this reason, in this section we will present only the results related to the analysis of the relationship between the nature of the majority shareholder and firm's performance.

The analysis of these data (Figures 12-13) shows significant differences on performance depending on who is the majority shareholder in the ownership

structure of the company. In summary, these are the main conclusions:

-Between 1997 and 2003, and considering all the analysed firms (including those that do not have a majority shareholder), ROA decreases from 8,7% to 6,7%, while ROE decreases from 12,5% to 6,4%.

-If we attend the relationship between ROA and the different types of majority shareholders, we observe that in 1997 bank-controlled firms show the best performance (15,2%), followed by companies controlled by non-bank financial institutions (8,9%), foreign firms (8,7%), individuals and families (8,6%), and nonfinancial domestic firms (8,5%). State-owned companies show the worst performance (2,6%).

-In 2003, ROA gets worse for all companies, but with different intensity depending on who is the majority shareholder: bank-owned firms continue being the best firms (14%), followed by companies owned by foreign firms (7,6%), non-financial domestic firms (7,4%), non-bank financial firms (7,3%) and individuals and families (7,0%). Therefore, between 1997 and 2003, the Spanish companies controlled by foreign firms and non-financial domestic firms improve their relative position according to this ratio (although their average ROA decreases), whilst those firms controlled by non-bank financial institutions and individuals and families do the contrary. Once again, state-owned companies show the worst performance ratio.

-In 1997, firms controlled by banks show the best ROE ratio (20,9%), followed by those companies where individuals and families (12,6%), non-financial domestic firms (9,6%), foreign firms (9%) and non-bank financial firms are the majority shareholders. State-owned firms show, on average, a negative ROE (-1,7%).

-Between 1997 and 2003, we observe a general and significant decrease in ROE ratio of all types of firms. In 2003, family-controlled firms show the best performance ratio (8%), followed by bank-owned companies (5,4%) and firms controlled by other nonfinancial Spanish firms (0,2%). The rest of the companies controlled by other types of shareholders show a negative value of ROE in 2003.

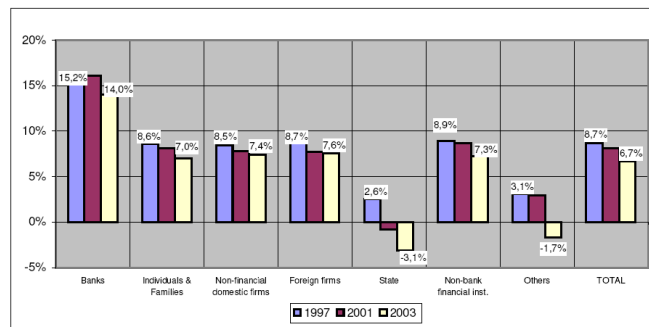


Figure 12. Majority shareholder and ROA

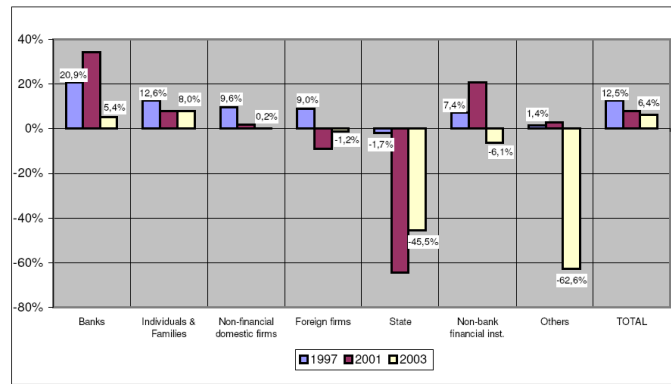


Figure 13. Majority shareholder and ROE

-If we compare ROA and ROE ratios, in 1997 we notice that ROE is larger than ROA in those firms controlled by banks, individuals and families, non-financial domestic firms and foreign firms, while is smaller in companies owned by the state and nonblank financial institutions. Six years later, in 2003, ROE is smaller than ROA in all companies except for family-owned firms.

5. Conclusions

Due to the fact that our aim was to analyse the evolution of ownership and control structures of Spanish firms between 1997 and 2006, and their possible influence on performance, we highlight the following conclusions of our study:

-Individuals and families play an important role in the ownership and control structures of Spanish firms. They participate in the biggest number of firms, although their average presence is not the most important, and seem to be focused on small firms. Non-financial domestic firms and foreign companies tend to concentrate their investment in a more reduced number of firms (notably greater in the case of the nonfinancial domestic firms) in which their presence clearly makes up the majority (especially in the case of foreign firms). Finally, the presence of non-bank financial institutions, banks and state is scarce as a whole. Their average share participation is reduced, and they own, in 2003, approximately 14,4 % of total equity. There seems to be a predominant participation in large sized firms. In the evolution from 1997 to 2006, it stands out an important increase in the average stake of all types of shareholders and a decrease in the percentage of firms participated by banks, state and non-bank financial institutions. Their place has been taken by non-financial domestic firms and individuals and families who increase simultaneously their average share stakes and the proportion of equities controlled in Spanish firms. It is important to highlight the growing importance of these inter-companies share holdings because in 2006 represent 48,1% of total equity of Spanish firms.

-Referring to the activity sectors, in 2006, important differences are observed. Foreign firms' investment interests are focused on industry, commerce and repair, whilst individuals and families show a preference for primary sector and construction. Banks, non-bank financial institutions and state maintain their holdings in the "other services" sector. Furthermore, non-financial Spanish firms maintain a balanced investment option in practically all the activity sectors, although with a certain predilection for firms in the construction sector.

-As far as size is concerned, in 2006, the investment interests vary depending on the type of shareholders. Foreign firms stand out for their preference for large sized firms, contrary to banks and individuals and families, who focus on small sized firms. No particular preferences are observed on other shareholders like non-financial domestic firms, state and non-bank financial institutions.

-From 1997 to 2006, it stands out an important movement of dominance from foreign firms, banks and state towards, above all, individuals and families. It is perceived an important increase in the concentration of ownership in, specially, those controlled by individuals and families, and to a lesser extent, by non-financial domestic firms. Thus, in 2006, individuals and families control the largest proportion of Spanish firms (although these firms represent only 16,8% of total equity), followed, at a certain distance, by non-financial domestic firms (their holdings represent almost half of total equity of Spanish firms). In relative terms, the percentage of firms controlled by other shareholders decreases.

-Finally, as far as the relationship between the nature of the majority shareholder and firm's performance is concerned, significant differences can be appreciated -in 1997 and, especially, in 2003-, both in the values of ROA and ROE. Companies controlled by banks and individuals and families show the best overall performance, while stateowned companies stand out for their poor outcome. In addition, it is important to highlight that ROA and ROE performance ratios get worse during the

analysed period. Besides, while in 1997 ROE is larger than ROA in firms controlled by banks, individuals and families, non-financial domestic firms and foreign firms, in 2003 only family-owned firms maintain this situation.

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Appendices

Table 1. Legal status of Spanish firms

Legal status	Legal status of Spanish firms							
	1997		2001		2003		2006	
	Firms	%	Firms	%	Firms	%	Firms	%
Associations	221	0.12%	552	0.28%	2.913	0.55%	3.356	0.39%
Cooperatives	725	0.40%	1.978	1.02%	6.289	1.19%	7.201	0.84%
Public limited companies	76.040	41.63%	67.467	34.76%	105.863	19.99%	114.565	13.32%
Limited companies	105.590	57.80%	123.973	63.88%	414.203	78.23%	734.407	85.42%
Others	91	0.05%	106	0.05%	217	0.04%	247	0.03%
TOTAL	182.667	100%	194.076	100%	529.485	100%	859.776	100%

Table 2. Size of Spanish firms

Employees	Size of Spanish firms							
	1997		2001		2003		2006	
	Firms	%	Firms	%	Firms	%	Firms	%
n.a.	87.830	48,08%	73.801	38,03%	145.677	27,51%	122.147	14,21%
1 – 9	55.988	30,65%	52.639	27,12%	260.095	49,12%	570.119	66,31%
10 – 19	17.935	9,82%	28.869	14,88%	63.108	11,92%	89.708	10,43%
20 – 49	13.737	7,52%	24.343	12,54%	41.229	7,79%	54.774	6,37%
50 – 249	5.983	3,28%	12.059	6,21%	16.682	3,15%	19.990	2,33%
249 – 499	996	0,55%	1.976	1,02%	2.239	0,42%	2.518	0,29%
More than 500	198	0,11%	389	0,20%	455	0,09%	523	0,06%
TOTAL	182.667	100%	194.076	100%	529.485	100%	859.779	100%

Table 3. Activity sector of Spanish firms

Description	Activity sector of Spanish firms							
	1997		2001		2003		2006	
	Firms	%	Firms	%	Firms	%	Firms	%
Primary	2.560	1,81%	3.222	1,70%	12.014	2,36%	20.295	2,40%
Industry	35.911	25,37%	47.922	25,30%	92.802	18,26%	121.452	14,36%
Construction	17.307	12,23%	23.710	12,52%	68.789	13,53%	117.171	13,85%
Commerce & repairs	46.180	32,62%	67.650	35,71%	142.067	27,95%	207.617	24,54%
Others services	39.606	27,98%	46.938	24,78%	192.676	37,90%	379.340	44,85%
TOTAL	141.564	100%	189.442	100%	508.348	100%	845.875	100%

Table 4. Firms participated by each type of shareholders

Type of shareholders	Firms participated by each type of shareholders							
	1997		2001		2003		2006	
	Firms	%	Firms	%	Firms	%	Firms	%
Banks	1.080	0,95%	1.003	0,84%	1.833	0,72%	2.709	0,74%
Individuals & Families	83.624	73,56%	83.691	70,09%	186.971	73,89%	263.728	72,10%
Non-financial domestic firms	21.274	18,71%	26.315	22,04%	50.715	20,04%	77.703	21,24%
Foreign firms	5.023	4,42%	5.251	4,40%	7.727	3,05%	14.277	3,90%
State	706	0,62%	864	0,72%	1.539	0,61%	1.846	0,50%
Non-bank financial institutions	1.853	1,63%	2.155	1,80%	4.017	1,59%	4.876	1,33%
Others	115	0,10%	132	0,11%	248	0,10%	660	0,18%
TOTAL	113.675	100%	119.411	100%	253.050	100%	365.799	100%

Table 5

Type of shareholder	Share stakes											
	1997			2001			2003			2006		
	Average	Stand. Dev.	%	Average	Stand. Dev.	%	Average	Stand. Dev.	%	Average	Stand. Dev.	%
Banks	38,25	40,64	38,06	32,41	38,06	40,42	40,00	40,42	43,60	40,51	36,58	
Individuals & Families	30,51	26,12	28,66	33,72	28,66	42,48	33,21	33,21	50,62	36,67	34,04	
Non-financial domestic firms	48,26	35,88	36,87	50,57	36,87	54,73	36,78	36,78	61,39	36,67	34,04	
Foreign firms	66,24	37,85	37,41	68,89	37,41	73,55	36,37	36,37	78,37	34,04	41,56	
State	51,03	39,61	39,91	50,81	39,91	48,62	40,93	40,93	54,36	39,29	37,96	
Non-bank financial institutions	35,50	37,04	37,26	36,56	37,26	40,57	37,95	37,95	45,50	32,63	37,96	
Others	42,94	40,54	37,49	40,65	37,49	39,81	37,17	37,17	32,63	37,96	37,96	

Table 6

Type of shareholder	Total equity owned by each type of shareholders											
	1997			2001			2003			2006		
	Equity (euros)	%	%	Equity (euros)	%	%	Equity (euros)	%	%	Equity (euros)	%	%
Banks	5.572.069.411 €	6,93%	9,09%	24.889.765.250 €	9,09%	5,85%	19.553.663.810 €	5,85%	17.186.806.276 €	4,42%	4,42%	
Individuals & Families	12.744.948.230 €	15,85%	12,72%	34.832.008.301 €	12,72%	16,07%	53.760.468.369 €	16,07%	65.335.094.979 €	16,81%	16,81%	
Non-financial domestic firms	37.656.485.318 €	46,83%	45,67%	125.110.225.424 €	45,67%	48,21%	161.254.286.562 €	48,21%	186.983.231.586 €	48,10%	48,10%	
Foreign firms	16.555.785.947 €	20,59%	21,13%	57.887.448.510 €	21,13%	18,77%	62.778.711.070 €	18,77%	79.316.933.280 €	20,41%	20,41%	
State	4.750.336.849 €	5,91%	3,78%	10.359.459.153 €	3,78%	4,04%	13.526.836.422 €	4,04%	11.906.461.874 €	3,06%	3,06%	
Non-bank financial institutions	2.745.933.354 €	3,41%	7,41%	20.304.179.050 €	7,41%	6,90%	23.065.038.405 €	6,90%	26.811.107.199 €	6,90%	6,90%	
Others	388.252.010 €	0,48%	0,20%	538.615.280 €	0,20%	0,16%	542.000.663 €	0,16%	1.159.951.241 €	0,30%	0,30%	
TOTAL	80.413.811.121 €	100%	100%	273.921.700.968 €	100%	100%	334.481.005.302 €	100%	388.699.586.434 €	100%	100%	

Table 7

Sector	Shareholders' portfolio sector bias-index													
	Banks		Individuals & Families		Non-financial domestic firms		Foreign firms		State		Non-bank financial inst.		Others	
	Index 1997	Index 2006	Index 1997	Index 2006	Index 1997	Index 2006	Index 1997	Index 2006	Index 1997	Index 2006	Index 1997	Index 2006	Index 1997	Index 2006
Primary	0.41	0.16	1.79	2.36	0.70	0.97	0.73	0.31	1.38	0.40	2.45	0.71	9.02	1.36
Industry	0.11	0.11	0.85	0.78	1.13	1.03	1.24	1.47	0.72	0.34	0.79	0.82	0.38	0.61
Construction	2.52	0.09	1.87	1.74	0.95	1.21	0.16	0.18	0.49	1.05	0.78	0.77	0.27	0.25
Commerce & Repair	0.05	0.07	1.49	1.48	0.94	0.81	1.37	1.64	0.37	0.14	0.34	0.27	0.86	0.67
Others services	2.57	1.79	0.74	0.91	0.87	1.01	0.61	0.68	1.85	1.57	1.66	1.29	1.76	1.35

Table 8

Size	Shareholders' portfolio size bias-index													
	Banks		Individuals & Families		Non-financial domestic firms		Foreign firms		State		Non-bank financial inst.		Others	
	Index 1997	Index 2006	Index 1997	Index 2006	Index 1997	Index 2006	Index 1997	Index 2006	Index 1997	Index 2006	Index 1997	Index 2006	Index 1997	Index 2006
1 - 9 employees	2.60	2.62	1.81	1.44	0.84	0.88	0.55	0.57	0.76	0.54	1.79	1.41	0.26	0.65
10 - 19 employees	0.89	1.27	2.17	1.72	0.87	0.85	0.45	0.69	0.77	1.43	1.59	0.93	0.12	0.20
20 - 49 employees	0.59	0.91	2.10	1.74	0.73	0.96	0.76	0.54	1.39	1.37	1.15	0.78	0.10	0.65
50 - 249 employees	0.74	0.55	1.17	0.85	0.94	1.13	1.12	0.98	0.63	0.97	1.10	0.76	1.63	1.41
249 - 499 employees	0.97	0.21	0.25	0.33	1.24	1.06	1.07	1.64	0.78	0.61	0.79	0.85	1.32	1.54
More than 500 employees	1.08	-0.48	0.05	0.15	1.05	1.07	1.38	1.65	2.19	1.93	0.28	1.06	0.66	1.05

Table 9
Nature of the predominant type of shareholder

Type of shareholder	1997			2001			2003			2006		
	Firms	%	Average	Firms	%	Average	Firms	%	Average	Firms	%	Average
Banks	361	0.91%	1.29	273	0.60%	1.48	642	0.56%	1.33	724	0.41%	1.33
Individuals & Families	25,398	64.19%	3.00	28,017	61.42%	2.71	79,076	69.56%	2.21	127,216	71.4%	1.86
Non-financial domestic firms	9,659	24.41%	1.43	12,695	27.83%	1.42	26,284	23.12%	1.35	40,259	22.59%	1.33
Foreign firms	3,198	8.08%	1.21	3,496	7.66%	1.17	5,513	4.85%	1.14	7,448	4.18%	1.28
State	358	0.90%	1.33	437	0.96%	1.36	735	0.65%	1.40	862	0.48%	1.84
Non-bank financial inst.	550	1.39%	1.35	654	1.43%	1.40	1,357	1.19%	1.23	1,535	0.86%	1.28
Others	43	0.11%	1.16	45	0.10%	1.13	78	0.07%	1.08	135	0.08%	1.02
TOTAL	39,567	100%	1.62	45,617	100%	1.46	113,685	100%	1.33	178,179	100%	1.22

Table 10

Type of shareholder	1997			2001			2003			2006		
	Participated	Under predominance	Ratio	Participated	Under predominance	Ratio	Participated	Under predominance	Ratio	Participated	Under predominance	Ratio
Banks	1,080	361	33.43%	1,003	273	27.22%	1,833	642	35.02%	2,709	724	26.73%
Individuals & Families	83,624	25,398	30.37%	83,691	28,017	33.48%	186,971	79,076	42.29%	263,728	127,216	48.24%
Non-financial domestic firms	21,274	9,659	45.40%	26,315	12,695	48.24%	50,715	26,284	51.83%	77,703	40,259	51.81%
Foreign firms	5,023	3,198	63.67%	5,251	3,496	66.58%	7,727	5,513	71.35%	14,277	7,448	52.17%
State	706	358	50.71%	864	437	50.58%	1,539	735	47.76%	1,846	862	46.70%
Non-bank financial inst.	1,853	550	29.68%	2,155	654	30.35%	4,017	1,357	33.78%	4,876	1,535	31.48%
Others	115	43	37.39%	132	45	34.09%	248	78	31.45%	660	135	20.45%
TOTAL	113,675	39,567	34.81%	119,411	45,617	38.20%	253,050	113,685	44.93%	365,799	178,179	48.71%

Table 11

Type of shareholder	Nature of majority shareholders							
	1997		2001		2003		2006	
	Firms	%	Firms	%	Firms	%	Firms	%
Banks	341	0.67%	250	0.43%	599	0.44%	784	0.36%
Individuals & Families	10471	20.58%	12934	22.35%	46178	34.00%	92432	42.36%
Non-financial domestic firms	8264	16.23%	11018	19.04%	23120	17.03%	39311	18.02%
Foreign firms	3074	6.04%	3393	5.86%	5377	3.96%	8452	3.87%
State	336	0.66%	411	0.71%	684	0.50%	915	0.42%
Non-bank financial inst.	518	1.02%	623	1.08%	1283	0.94%	1721	0.79%
Others	42	0.08%	42	0.07%	76	0.06%	172	0.08%
No majority shareholder	27837	54.71%	29205	50.46%	58481	43.06%	74396	34.10%
TOTAL	50,879	100%	57,876	100%	135,798	100%	218,183	100%

Table 12

Predominant type of shareholder	ROA						ROE		
	1997		2003		1997		2001		2003
Banks	0.15	0.14	0.13	0.21	0.21	0.33	0.33	0.08	
Individuals & Families	0.08	-0.03	-0.16	0.15	-0.05	-0.25	-0.25	2.25	
Non-financial domestic firms	0.07	0.06	-0.07	0.11	-0.16	-0.54	-0.54	0.27	
Foreign firms	0.06	0.06	0.00	0.09	0.09	0.20	0.69	1.37	
State	0.03	-0.14	-0.06	0.20	0.10	0.25	0.18	0.18	
Non-bank financial inst.	0.08	0.07	0.05	0.10	0.10	0.13	0.13	-0.57	
Others	0.03	0.03	-0.01	0.04	0.04	0.15	-0.45	0.19	
TOTAL	0.08	0.05	-0.43	0.15	0.15	-0.45	0.19		

Table 13

Majority shareholder	ROA						ROE		
	1997		2003		1997		2001		2003
Banks	0.15	0.15	0.13	0.22	0.22	0.37	0.37	0.06	
Individuals & Families	0.08	-0.14	-0.29	0.14	-0.30	-0.44	-0.44	1.64	
Non-financial domestic firms	0.07	0.06	-0.07	0.10	-0.18	-0.56	-0.56	0.27	
Foreign firms	0.06	0.06	0.00	0.08	0.08	0.21	0.74	-0.15	
State	0.03	-0.12	-0.05	0.21	0.11	0.25	0.25	-0.59	
Non-bank financial inst.	0.09	0.07	0.06	0.11	0.11	0.03	0.03	-0.19	
Others	0.03	0.03	-0.02	0.01	0.01	0.15	-0.45	0.19	
TOTAL	0.08	0.04	-0.43	0.15	0.15	-0.45	0.19		

INSTITUTIONAL OWNERSHIP AND FIRM'S DIVIDEND POLICY

Weiye Guo*, Jinlan Ni**

Abstract

This paper examines the linkage between dividend policy and institutional ownership within the context of the dividend model of Allen, Bernardo and Welch (2000). Specifically, it provides an empirical test of Allen, Bernardo and Welch (2000)'s novel implication that a tax differential between institutions and retail investors effects dividend policies. Using merge data of US industrial firms from 1980-2002, our results indicate that the dividend paying decision is positively related with institutional ownership. That is, firms with higher institutional ownership are more likely to be dividend payers. Further, we find that the deferred tax or tax credits that the institutional investors own significantly contribute to the dividend initiation decision as well as the level of dividend payments.

Keywords: Institutional ownership, dividend policy

* Associate Professor, Department of Finance, University of Nebraska at Omaha, 6001 Dodge Street, Omaha, NE 68182
Tel/Fax: 402-554-2655/ 402-554-3747, Email: wguo@unomaha.edu

** Assistant Professor, Department of Economics, University of Nebraska at Omaha, 6001 Dodge Street, Omaha, NE 68182,
Omaha, NE 68182

Tel: (402)554-2549, Email: jni@unomaha.edu

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1. Introduction

Miller and Modigliani (1961) suggested that in a frictionless world without taxes or transaction costs, dividends and share repurchases are equivalent policies. Thus a company's dividend policy is irrelevant to the value of the firm. When dividends are taxed more heavily than stock subject to capital gains rates, which had been the case under the IRS tax code until the 2003 tax reform act, then share repurchases would appear to be superior to dividends. We would therefore anticipate more share repurchases than dividends due to the tax differential. The actual data indicate, however, that there is a significant proportion of dividend payers and a larger percentage of dividend paying firms than firms making share repurchases. This is called the dividend puzzle.

There is a growing body of literature attempting to explain the dividend puzzle. One explanation relates to the 1974 Employee Retirement Income Security Act (ERISA). ERISA subjected private pension fund managers to the prudent man rule. The application of the prudent man rule led to investment policy and institutional charter restrictions that require institutions to favor dividend paying stocks, especially those with high dividend yields. Brav and Heaton (1998) documented that many institutional investors abandoned dividend-omitting firms after the prudent man rule was required. And when firms reinitiated dividends, the effect reversed.

Tax-exempt institutions also favor higher dividend yields because of their higher pretax expected returns. Shleifer and Vishny (1986) recognized that dividends can be a mechanism to compensate institutional investors. Michaely, Thaler, and Womack (1995) examined volume changes around dividend changes as indicators of clientele rearrangements.²⁵ Dhaliwal, Erickson, and Trezevant (1998) found that the initiation of dividend payments led to an increase in institutional ownership. Specifically, they found that tax-exempt/tax-deferred and corporate investors increased their ownership in firms that initiated cash dividends as these investors purchased shares sold by individual investors for whom dividends were tax-disadvantaged. These studies provided evidence that institutional ownership and firm dividend policy are related and led to increased interest in further examining the direct linkage between dividend policy and institutional ownership.

More recently, Allen, Bernardo and Welch (2000) examined how a tax differential between individual investors and institutional investors would impact a firm's dividend policy. They predicted that when institutional investors are relatively less taxed than individual investors, dividends induce "ownership clientele" effects. Their prediction is

²⁵ For a rather comprehensive review of some earlier work regarding dividend policy and institutional ownership, please refer to Allen and Michaely (1995).

based on two assumptions. First, investors are taxed differently and invest rationally, so dividends can induce specific clientele changes. Second, the presence of institutional clientele can increase the value of the firm. Consequently, firms paying dividends attract relatively more institutions, and institutions have a relative advantage in detecting high quality firms and in ensuring that firms are well managed. The Allen, Bernardo and Welch (2000) model found that by titling their portfolios in favor of dividend-paying stocks, tax-exempt institutions gain higher rates of return even though they may incur a loss of some diversification benefits and an increase in monitoring costs.

Short, Zhang and Keasey (2002) examined the role of institutional ownership in relation to dividend payout ratios within the context of the dividend models of Lintner (1956), Waud (1966), and Fama and Babiak (1968) using a United Kingdom (UK) panel data set. Using dummy variables for ownership data, they found positive association between a dividend payout policy and institutional ownership. Tax effects, however, were not directly tested and the institutional framework and ownership structures in UK are quite different from those of the US.

Baker and Wurgler (2003) proposed a catering theory of dividends. They argued that the decision to pay dividends is driven by prevailing investor demand for dividend payers. Their theory implies a close link between fluctuations in the propensity to pay dividends and catering incentives. Relying on regressions of future excess returns of dividend-payers and non-dividend-payers on the changes in the propensity to pay dividends, their empirical work explained the post-1977 disappearance of dividends as well as earlier appearances and disappearances. Baker and Wurgler (2003), however, did not specify for whom the firms are catering.

This paper provides an empirical test of Allen, Bernardo and Welch (2000)'s implication that a tax differential between institutions and retail investors affects dividend policies. When institutional investors' deferred taxes & investment tax credits increase, we anticipate that they have increased demand for dividend payments because deferred taxes and investment credits can offset dividend payments for tax purposes. Hence we predict that institutional investors' deferred taxes & investment tax credits are positively correlated with the probability of a firm being a dividend payer as well as the level of dividend payment. Using dividend data from the CRSP/COMPUSTAT merged database and institutional ownership data from the Thomson Financial CDA/Spectrum S34 13f Institutional Holdings from 1980-2002, excluding financial and utility firms, we first examine the linkage between dividend policy and institutional ownership using a logit regression, then examine the relationship between the level of dividend payment and institutional ownership deferred tax or investment tax

credit using cross-section time series data. Our results are consistent with our hypotheses.

Our paper contributes to the literature by empirically testing how institutional ownership and institutional deferred taxes and investment tax credits affect firm dividend policies. While Dhaliwal, Erickson, and Trezevant (1998) provided evidence that the effects of tax clienteles for dividend policies are strong enough to influence the decisions of investors, our paper provides evidence from a different perspective – that is, higher institutional ownership and larger institutional deferred taxes and tax credits induce higher dividend payments. Our paper also sheds light on the question - for whom are firms catering their dividends. This question was left unanswered in Baker and Wurgler (2003). The theory provided by Allen, Bernardo and Welch (2000) behind our empirical work further allows us to improve on Short, Zhang and Keasey (2002) by using actual ownership data instead of dummy variables to examine the direct linkage between the change of dividend payment and institutional ownership. The use of ownership dummy variables in Short, Zhang and Keasey (2002) made it difficult to characterize different dividend payments across firms with institutional ownership.

The rest of the paper is organized as follows. Section 2 describes the sample and variables. Section 3 presents the hypotheses and methodology. Section 4 reports the results. Section 5 summarizes the paper.

2. Sample, Variables and Time Trends

2.1 Sample and variables

Data are from two sources - the CRSP/COMPUSTAT merged database and the Thomson Financial CDA/Spectrum S34 13f Institutional Holdings. Sample period is 1980-2002. From the CRSP/COMPUSTAT merged data, we extract dividends per share (Item DATA26 in the database), stock price per share (DATA199), common shares outstanding (DATA25), Deferred Tax & Invest Tax Credit (DATA35), Deferred Taxes at income account (DATA50), Investment Tax Credit at income account (DATA51) and Deferred Taxes at balance sheet (DATA74). We further extract equity in the Balance Sheet and use it as a proxy for book value per share to calculate the book value / market value (BV/MV) ratio for subsequent regression analysis. Following Fama and French (2000), a firm must have market equity data at year t to be in the sample for the year. Both utility firms (SIC codes 4900-4949) and financial firms (SIC codes 6000-6999) are excluded. These industries may have regulatory requirements for high dividend payouts which are independent of any benefits of attracting institutions.

From the Thomson Financial CDA/Spectrum S34 13f Institutional Holdings database we extract the number of shares held by managers at the end of each of quarter (variable SHARES at 13f database). Since 13f data are aggregated to a manager level, we then

calculate institutional holdings by totaling all manager level holdings based on manager number (MGRNO) for each quarter. Given that the CRSP/COMPUSTAT data are annual data while the 13f are quarterly data, we retain number of shares as of the last quarter as institutional holding in a particular year. We also further extract industry code (Industry) for subsequent regression analysis. The variables from the two datasets are then merged through an 8 digit CUSIP of the stock and YEAR in consideration. After the data are merged, we calculate institutional ownership in percentage terms (INST) by dividing institutional holdings by the total common shares outstanding. If a ratio is outside of the range of 0-1, the observation is treated as an outlier and is deleted.

Similar to Fama and French (2000), we then classify sample firms into two categories – those who pay dividends (Payer) and those who do not pay dividend (Non-payer). In the Payer group, those newly listed firms that are dividend payers are further recognized as Newpayer. The Non-payers are also further separated into 1) those having never paid (Neverpaid); and 2) those formerly paying but then having stopped paying (Formerpayer). Following Fama and French (2001), these are the "firms that do not pay in year t but did pay in a previous year".

Table 1 gives the summary statistics of the key variables. It shows that 47% of the observations in the sample are Payers (3% of which are Newpayers) and 53% are Non-payers (8% Former-payers and 45% Neverpays). Note the summation of Payer and Non-payer equals one. Table 1 also shows that the mean dividend per share in our sample is \$0.35 on an annual basis with a standard deviation of 0.89 and the mean annual institutional ownership is 27% with a standard deviation of 0.24. Mean market capital of the sample firms is about \$1,576 million and mean book to market value ratio is 0.51. The table further reports the means and standard deviations of the deferred tax and investment tax credit measures. Mean institutional Deferred Tax and Investment Tax Credit and Deferred Taxes at Balance Sheet are \$62.41 and \$62.95 respectively, with standard deviations of 412.09 and 411.09. The means of Deferred Tax at Income Account and Investment Tax Credit at Income Account are \$1.47 and \$1.52 respectively and the standard deviations are 88.93 and 15.45. Note the numbers of Deferred Tax & Invest Tax Credit and Deferred Taxes at Balance Sheet are similar, because both measures represent the accumulated tax deferrals due to timing differences between the reporting of revenues and expenses for financial statements and tax purposes with small differences in the items being excluded in the calculations²⁶. Similarly, Deferred Tax at Income Account and Investment Tax Credit at Income Account both represent the amortized portion of tax savings that reduces the current year's tax liability.

²⁶ Please refer to CRSP manual for details of how the items are defined.

Table 1 about here

2.2 Time trend in dividends and institutional ownership

Figure 1A shows the percentage of dividend paying firms vs. non-dividend paying firms over time. The proportion of Payers declines consistently throughout sample period from about 60% in 1980 to just slightly over 30% in 2002. This observation is consistent with the patterns documented in Fama and French (2001). Conversely, the proportion of non-dividend paying firms has been increasing concavely from about 40% in 1980 to close to 70% in 2002.

Figure 1B shows the percentage of newly listed firms that are dividend payers from 1980-2002. In 1980, the percentage of newly listed firms that are dividend payers was as high as 60%. Over the years, the percentage declined significantly to as low as under 10% from 1995-1997 before increasing to over 40% in 2001. In 2002, the percentage declined to under 30%. Figure 1C shows the percentage of firms that having never paid dividends vs. those former dividend payers. Among the non-dividend paying firms, the percentages of Formerpayers are much lower than those of the Neverpays over the years. In fact, the percentage of former payers shows a declining trend. The percentage declined from slightly under 30% in the early 80s to below 10% in 2002, indicating a trend of fewer firms terminating dividend payments over time.

Figure 1A, 1B, and 1C about here

Figure 2 illustrates the amounts of dividends being paid on a yearly basis compared with mean annual level of institutional ownerships throughout the sample period. Institutional ownership has increased steadily from slightly less than 20% to just below 35% from 1980 to 2002. Consistent with the literature, average annual dividends also demonstrate a steadily increasing pattern. It increased from under \$0.15 per share in 1980 to over \$0.35 per share in 2002. While we observe that average annual dividend amount are increasing, recall that Figure 1A shows the percentage of firms that are dividend payers is declining. A possible explanation for these observed patterns is even though the number of firms paying dividends has been decreasing, dividend paying firms increase the dividend amounts as institutional ownership increases.

Figure 2 about here

3. Hypotheses, Methodology, and Results

3.1 Hypotheses

Our testable hypotheses are based on Allen, Bernardo and Welch (2000) that institutional ownership affects the firm's dividend policy. We expect that:

(1). Dividend Payers are more likely to associate with institutional investors than Non-payers. Assuming investors are taxed differently and invest rationally, Allen, Bernardo and Welch (2000) predicted that there is an “ownership clientele” effect. Consequently, firms paying dividends attract relatively more institutional investors.

(2). Dividend Payers with institutional ownership are more likely continue to be future payers than Non-payers. This hypothesis is based on the smoothing effect discussed in Allen, Bernardo, and Welch (2000). Firms that pay dividends try not to reduce the amount of the dividend, because their clientele (institutions) are precisely the kind of investors that will punish them for it. Thus dividend paying firms will try to keep dividends relatively smooth.

(3). Dividend Payers are more likely to associate with large deferred taxes and investment credits than Non-payers. When institutional investors have deferred taxes & investment tax credits, they favor dividends because dividends can offset the deferred taxes and investment credits for tax purposes. Hence we see dividend Payers are more likely to associate with deferred taxes and investment credits than Non-payers.

(4). Dividend amount is positively related with institutional ownership. Due to institutional investors’ demand for dividend payments, we expect to see that firms with higher institutional ownership are related to higher dividend payouts.

(5). Dividend amount is positively correlated with the level of institutional investors’ deferred taxes & investment tax credits. Given dividends can induce clientele changes, Allen, Bernardo and Welch (2000) predict that tax differences between institutions and retail investors are significant determinants of dividend payments. Hence we predict that higher institutional investors’ deferred taxes & investment tax credits are associated with higher dividend amounts.

Logit and time-series cross sectional regressions are applied to test the hypotheses. Model specifications and regressions results are presented in the following subsections.

3.2 Methodology

3.2.1 Logit regression models

Before we begin our regression analysis, we examine the correlations between the independent variables and future regression dependent variable Dividend per Share. The numbers are reported in Table 2 showing positive correlations. Further, note that the correlations among the different tax credit measures, such as Deferred tax and Investment Tax Credit and Deferred Taxes at Balance Sheet, are high (0.9967), we hence use one tax credit measure at a time in the subsequent regression analyses.

Table 2 about here

To test Hypothesis (1), we first adopt the following logit models

$$\text{Prob}(\text{Payer}_{i,t}=1) = \alpha + \beta \text{Inst}_{i,t} + \delta \text{Size}_{i,t} + \gamma(\text{BV/MV})_{i,t} + \phi \text{Industry}_{i,t} + \sum_{1981}^{2002} \theta_t \text{Year}_t + \varepsilon_{i,t} \quad (\text{Model 1})$$

$$\text{Prob}(\text{Newpayer}_{i,t}=1) = \alpha + \beta \text{Inst}_{i,t} + \delta \text{Size}_{i,t} + \gamma(\text{BV/MV})_{i,t} + \phi \text{Industry}_{i,t} + \sum_{1981}^{2002} \theta_t \text{Year}_t + \varepsilon_{i,t} \quad (\text{Model 2})$$

$\text{Payer}_{i,t}$ equals to 1 if firm $_i$'s dividend per share at Year $_t$ is positive; 0 otherwise. $\text{Inst}_{i,t}$ is the percentage of firm $_i$'s stock owned by institutional investors at Year $_t$. Factors related to the probability being dividend payer, i.e., size, which is measured by market capital, BV/MV ratio, and industry classification are used as control variables.

Based on the hypothesis, the coefficients for $\text{Inst}_{i,t}$ is expected to be positive signaling a positive relationship between institutional ownership and a firm being a dividend payer.

To test Hypothesis (2), we examine the determinants of former dividend payers and firms having never paid dividend as follows.

$$\text{Prob}(\text{Formerpayer}_{i,t}=1) = \alpha + \beta \text{Inst}_{i,t} + \delta \text{Size}_{i,t} + \gamma(\text{BV/MV})_{i,t} + \phi \text{Industry}_{i,t} + \sum_{1981}^{2002} \theta_t \text{Year}_t + \varepsilon_{i,t} \quad (\text{Model 3})$$

$$\text{Prob}(\text{Neverpaid}_{i,t}=1) = \alpha + \beta \text{Inst}_{i,t} + \delta \text{Size}_{i,t} + \gamma(\text{BV/MV})_{i,t} + \phi \text{Industry}_{i,t} + \sum_{1981}^{2002} \theta_t \text{Year}_t + \varepsilon_{i,t} \quad (\text{Model 4})$$

Based on the hypothesis, we expect to see the coefficients for $\text{Inst}_{i,t}$ to be negative for Neverpaid and Formerpayers confirming it is less likely these firms would stop paying dividends or having never paid dividends when institutional ownership is high.

To test deferred tax or tax credit and the probability of a firm being a dividend payer as in Hypothesis (3), we first adopt the following models:

$$\text{Prob}(\text{Payer}_{i,t}=1) = \alpha + \chi \text{Deftax}_{i,t} + \delta \text{Size}_{i,t} + \gamma(\text{BV/MV})_{i,t} + \phi \text{Industry}_{i,t} + \sum_{1981}^{2002} \theta_t \text{Year}_t + \varepsilon_{i,t} \quad (\text{Models 5-8})$$

Where $\text{Deftax}_{i,t}$ is deferred tax or tax credit, which is Deferred Tax & Investment Tax Credit, Deferred Taxes at income account, Investment Tax Credit at income account or Deferred Taxes at balance sheet, one tax measure at a time, in models 5-8. Based on our hypotheses, the coefficients for $\text{Deftax}_{i,t}$ are expected to be positive signaling a positive relationship between a firm being a dividend payer and institutional tax benefits.

We subsequently adopt the following multivariate models to jointly test the relationship between a dividend payer and institutional ownership and institutional deferred tax and tax credit.

$$\begin{aligned} \text{Prob}(\text{Payer}_{i,t} = 1) = & \alpha + \beta \text{Inst}_{i,t} + \chi \text{Deftax}_{i,t} + \delta \text{Size}_{i,t} + \gamma (\text{BV/MV})_{i,t} + \phi \text{Industry}_{i,t} \\ & + \sum_{1981}^{2002} \theta_t \text{Year}_t + \varepsilon_{i,t} \end{aligned}$$

(Models 9-12)

We expect both coefficients for $\text{Inst}_{i,t}$ and $\text{Deftax}_{i,t}$ to be positive signaling a positive relationship between the likelihood of dividend payers and institutional tax credits when institutional ownership is controlled for.

3.3.1 Cross sectional time-series regression models

The following linear unbalanced panel data univariate regressions and multivariate regressions are conducted to test the direct relationship between dividend payments and tax difference as well as institutional ownership as in Hypotheses (4) and (5)

$$\text{Dividend}_{i,t} = \alpha + \beta \text{Inst}_{i,t} + \delta \text{Size}_{i,t} + \gamma (\text{BV/MV})_{i,t} + \phi \text{Industry}_{i,t} + \sum_{1981}^{2002} \theta_t \text{Year}_t + \varepsilon_{i,t}$$

(Model 13)

$$\text{Dividend}_{i,t} = \alpha + \chi \text{Deftax}_{i,t} + \delta \text{Size}_{i,t} + \gamma (\text{BV/MV})_{i,t} + \phi \text{Industry}_{i,t} + \sum_{1981}^{2002} \theta_t \text{Year}_t + \varepsilon_{i,t}$$

(Models 14-17)

$$\text{Dividend}_{i,t} = \alpha + \beta \text{Inst}_{i,t} + \chi \text{Deftax}_{i,t} + \delta \text{Size}_{i,t} + \gamma (\text{BV/MV})_{i,t} + \phi \text{Industry}_{i,t} + \sum_{1981}^{2002} \theta_t \text{Year}_t + \varepsilon_{i,t}$$

(Models 18-21)

$\text{Dividend}_{i,t}$ is the dividend per share paid by firm i at year t . The other variables have the same definition as before. Similarly, we expect that both coefficients for institutional ownership and tax credits will be positive.

4. Results

4.1 Logit regression results

Table 3 presents the results of the logit regressions. At column (1) where the dependent variable is current payers and the independent variable is $\text{Inst}_{i,t}$, the coefficient for $\text{Inst}_{i,t}$ is positive (1.263) and statistically significant at the one percent level as expected. This indicates Payers are more likely to associate with institutional ownership. Interestingly, different from what we expected to see at column (2), when the dependent variable is newly listed firms that pay dividends (Newpayers), the coefficient is negative (-1.166) and statistically significant at the 1% level. By examining the data, we find that the average institutional ownership for newly listed firms is much lower than the others. Thus, as Fama and French (2000) suggested, we believe that the dividend payment decision for newly listed firms is more likely to be determined by the characteristics of firms that have never paid dividends. In column (3) when the dependent variable is Formerpayer, the coefficient for $\text{Inst}_{i,t}$ is negative (-1.984) and the coefficient is again statistically significant. The negative correlation is consistent with hypothesis (3). It can be interpreted as firms with larger institutional ownership are less likely to stop paying dividends. Similarly, when the

dependent variable is Neverpaid as in column (4), the significant negative estimate (-1.166) implies that firms with higher proportions of institutional investors are less likely to be firms that have never paid dividends. These results support the theory that firms decide to pay dividends to attract relatively more institutions, and institutions have a relative advantage in detecting high firm quality and in ensuring that firms are well managed.

Columns 5-8 in Table 3 provide the estimation results of the deferred tax or tax credit effect on the probability of being a dividend payer. As we can see from the table, the coefficients for all four deferred tax measures are positive (0.005, 0.02, 0.001 and 0.005 respectively) and statistically significant at the one percent level.

The last four columns (9-12) in Table 3 report multivariate regression results. The coefficients for $\text{Inst}_{i,t}$ in the four models are 2.218, 1.931 and 2.364 and 2.197 respectively while the corresponding $\text{Deftax}_{i,t}$ coefficients are 0.004, 0.01, 0.00, and 0.004 respectively. These results are consistent with those from the univariate regressions, confirming the implication of the Allen, Bernardo and Welch (2000) theory that tax differences between institutions and retail investors are significant determinants of dividend payments.

Table 3 about here

4.2 Cross sectional time-series regression results

The regression results are reported in Table 4. The first 5 columns report the univariate results and columns 6-9 report the multivariate results. The results from both univariate regressions and the multivariate regressions are consistent hence we only discuss the multivariate results. Consistent with the results in Table 3, coefficients for institutional ownership and tax credits are positive and statistically significant at the one percent level. For example, the coefficient for $\text{Inst}_{i,t}$ is 0.272, 0.267, 0.250 and 0.272 respectively when the tax credit measures are Deferred Tax & Investment Tax Credit, Deferred Taxes at income account, Investment Tax Credit at income account and Deferred Taxes at balance sheet respectively. These results are consistent with Hypotheses (3) and (4) suggesting that the dividend amount is positively correlated with institutional ownership and deferred tax and investment tax credits. Note that in the regressions, all year dummies are included but the results are not reported for space efficiency. Further, we also look at the same analysis in a dynamic setting, that is, we look at how changes of institutional ownership and deferred tax and tax credits effect changes in dividend payments. The results are positive as expected, they are, however, not significant. Hence we are not reporting them here.

Table 4 about here**5. Summary**

This paper examines the link between dividend policy and institutional ownership within the context of the dividend theory of Allen, Bernardo and Welch (2000). Using dividend data from the CRSP/COMPUSTAT merged database and institutional ownership data from the Thomson Financial CDA/Spectrum S34 13f Institutional Holdings from 1980-2002, excluding all financial and utilities firms, we first examine the linkage between dividend policy and institutional ownership using a logit regression, then examine the relationship between the level of dividend payment and institutional ownership and institutional deferred tax or tax credit using cross-section time series data. The results from our regressions provide support for the hypothesis that dividend payers are more associated with institutional investors than non-payers. That is, the firms with higher institutional ownership are more likely to pay and continue to pay dividends. Further, we find that tax credit or deferred taxes significantly contribute to the initiation of the dividend and the dividend amount. These results support the predictions in Allen, Bernardo and Welch (2000).

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Appendices**Table 1.** Summary Statistics

Variable	Obs	Mean	Std. Dev.
Current Dividend Payer (yes=1 no=0)	68,476	0.47	0.50
New Dividend Payer (yes=1 no=0)	68,562	0.03	0.17
Not Current Dividend Payer (yes=1 no=0)	68,476	0.53	0.50
Former Dividend Payer (yes=1 no=0)	68,562	0.08	0.27
Never Paid Dividend (yes=1 no=0)	68,562	0.45	0.50
Dividend Per Share (\$)	68,476	0.35	0.89
Total Dividend (million\$)	68,476	27.69	175.29
Retained Earnings (million\$)	13,270	165.68	852.50
Deferred Tax & Invest Tax Credit (million\$)	55,469	62.41	412.09
Deferred Tax (Income Account) (million\$)	52,013	1.47	88.93
Deferred Taxes (Balance Sheet) (million\$)	53,622	62.95	411.57
Investment Tax Credit (Income Acct) (million\$)	33,094	1.52	15.45
Annual Institutional Ownership	68,562	0.27	0.24
Market Cap Value (million\$)	68,530	1,576.84	9,775.24
Book to Market Ratio	62,211	0.51	4.76

Data are from two sources - the CRSP/COMPUSTAT merged database and the Thomson Financial CDA/Spectrum S34 13f Institutional Holdings. Sample period is 1980-2002. Table 1 gives the summary statistics of the key variables in the sample.

Table 2. Correlation Table

	Institutional Ownership	Dividend per Share	Deferred Tax & Invest Tax Credit	Deferred Tax (Income Account)	Invest. Tax Credit (Income Acct)	Deferred Taxes (Balance Sheet)	Market Cap Value	Book to Market Ratio
Institutional Ownership	1							
Dividend per Share	0.0802	1						
Deferred Tax & Invest Tax Credit	0.0904	0.185	1					
Deferred Tax (Income Account)	0.0363	0.0432	0.2326	1				
Investment Tax Credit (Income Acct)	0.041	0.174	0.2312	0.0252	1			
Deferred Taxes (Balance Sheet)	0.0914	0.174	0.9967	0.2319	0.1955	1		
Market Cap Value	0.092	0.1029	0.5115	0.1176	0.1089	0.5165	1	
Book to Market Ratio	-0.0381	0.0082	-0.0088	0.0024	0.0054	-0.0093	-0.0228	1

Data are from two sources - the CRSP/COMPUSTAT merged database and the Thomson Financial CDA/Spectrum S34 13f Institutional Holdings. Sample period is 1980-2002. Table 2 reports the correlation between the independent variables and the dependent variable (Dividend) in the subsequent regressions. Notice that the correlations among the different taxes are high, so we use one tax variable at a time in the subsequent regression analysis.

Table 3. The Effect of Institutional Ownership and Tax Credits on the Probability of Dividend Payment

Logit Model: The dependant variable equals 1 if the company is the current dividend payer for model 1 and model 5-12, otherwise 0. The dependant variable equals 1 if the company is a former dividend payer in model 2, never paid dividend in model 3 and new dividend payer in model 4, otherwise 0.												
Independent Variables	Current Dividend Payer	New Dividend Payer	Former Dividend Payer	Never Paid Dividend	Current Dividend Payer	Current Dividend Payer	Current Dividend Payer	Current Dividend Payer	Current Dividend Payer	Current Dividend Payer	Current Dividend Payer	Current Dividend Payer
Models	1	2	3	4	5	6	7	8	9	10	11	12
Institutional Ownership	1.263 (0.038)**	-1.427 (0.172)*	-1.984 (0.080)**	-1.166 (0.037)*					2.218 (0.045)**	1.931 (0.057)**	2.364 (0.046)**	2.197 (0.046)**
Deferred Tax & Invest Tax Credit					0.005 (0.000)**				0.004 (0.000)**			
(DATA35)												
Investment Tax Credit						0.020				0.010		

Table 3 continued

(Income Acct, DATA51)												(0.003)**
Deferred Tax (Income Account, DATA50)							0.001 (0.000)**					0.000 (0.000)**
Deferred Taxes (Balance Sheet, DATA74)								0.005 (0.000)**				0.004 (0.000)**
Market Cap Value	0.000 (0.000)*	0.000 (0.000)*	-0.000 (0.000)**	-0.000 (0.000)**	0.000 (0.000)**	0.000 (0.000)**	0.000 (0.000)**	0.000 (0.000)**	0.000 (0.000)**	0.000 (0.000)**	0.000 (0.000)**	0.000 (0.000)**
Book to Market Ratio	0.257 (0.013)**	0.157 (0.030)**	-0.003 (0.002)	-0.099 (0.011)*	0.109 (0.012)**	0.053 (0.014)**	0.110 (0.013)**	0.116 (0.013)**	0.185 (0.014)**	0.112 (0.017)**	0.193 (0.015)**	0.191 (0.015)**
Industry Code Number	-0.000 (0.000)**	0.000 (0.000)**	0.000 (0.000)**	0.000 (0.000)**	-0.000 (0.000)**	-0.000 (0.000)**	-0.000 (0.000)**	-0.000 (0.000)**	-0.000 (0.000)**	-0.000 (0.000)**	-0.000 (0.000)**	-0.000 (0.000)**
Constant	0.939 (0.069)**	1.067 (0.108)**	-1.236 (0.075)**	-1.195 (0.069)**	1.737 (0.072)**	2.073 (0.085)**	1.876 (0.075)**	1.697 (0.072)**	1.399 (0.073)**	1.775 (0.086)**	1.485 (0.076)**	1.362 (0.074)**
Observations	62140	62211	62211	62211	55170	32899	51755	53335	55170	32899	51755	53335

Table 4. Linear Effect of Institutional Ownership and Tax on Dividend Payment

Independent Variables	Current Dividend Payer									
	13	14	15	16	17	18	19	20	21	21
Models										
Institutional Ownership	0.214 (0.021)***					0.272 (0.021)***	0.250 (0.024)***	0.267 (0.020)***	0.272 (0.022)***	
Deferred Tax & Invest Tax Credit		0.000 (0.000)***				0.000 (0.000)***				
Investment Tax Credit (Income Acct)			0.003 (0.000)***				0.003 (0.000)***			
Deferred Tax (Income Account)				0.000 (0.000)**				0.000 (0.000)**		
Deferred Taxes (Balance Sheet)					0.000 (0.000)***				0.000 (0.000)***	
Market Cap Value	0.000 (0.000)***	-0.000 (0.000)	0.000 (0.000)***	0.000 (0.000)***	0.000 (0.000)	-0.000 (0.000)	0.000 (0.000)***	0.000 (0.000)***	0.000 (0.000)	-0.000 (0.000)
Book to Market Ratio	0.000 (0.001)	0.000 (0.001)	-0.002 (0.002)	0.000 (0.001)	0.000 (0.001)	0.000 (0.001)	-0.002 (0.002)	0.000 (0.001)	0.000 (0.001)	0.000 (0.001)
Industry Code Number	-0.000 (0.000)	-0.000 (0.000)***	-0.000 (0.000)***	-0.000 (0.000)***	-0.000 (0.000)***	-0.000 (0.000)***	-0.000 (0.000)***	-0.000 (0.000)***	-0.000 (0.000)***	-0.000 (0.000)***
Constant	0.536 (0.026)***	0.601 (0.027)***	0.688 (0.027)***	0.583 (0.025)***	0.596 (0.026)***	0.574 (0.027)***	0.657 (0.027)***	0.559 (0.025)***	0.569 (0.026)***	
Observations	62140	55170	32899	51755	53335	55170	32899	51755	53335	

Standard errors in parentheses. * indicates significance at 10%; ** significance at 5%; *** significance at 1%
 Data are from two sources - the CRSP/COMPUSTAT merged database and the Thomson Financial CDA/Spectrum S34 13f Institutional Holdings. Sample period is 1980-2002. All year dummies are included but chosen not to report them for space efficiency.

Figure 1A. Percentage of Dividend Paying Firms vs. Non-Dividend Paying Firms 1980-2002

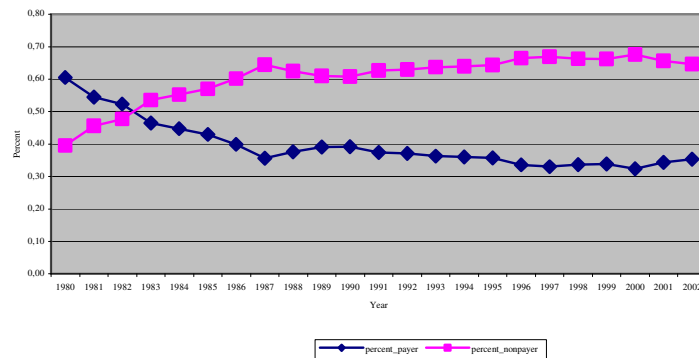


Figure 1B. Percentage of Newly Listed Firms That Are Dividend Payers 1980-2002

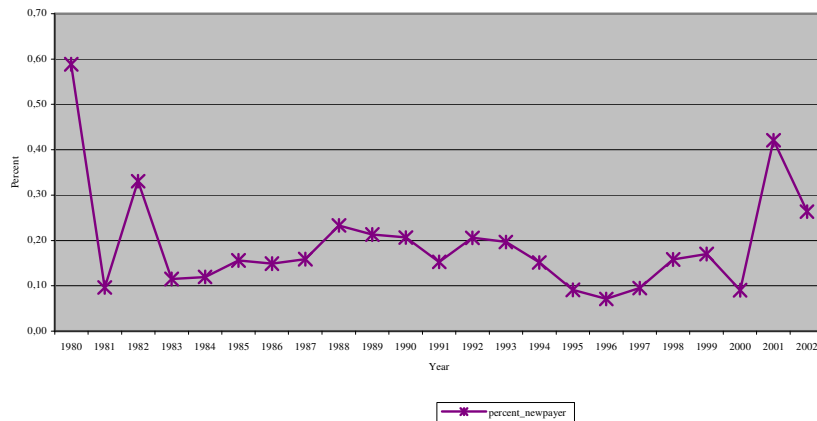


Figure 1C. Percentage of Firms of Formerly Having Paid vs. Firms Having Never Paid 1980-2002

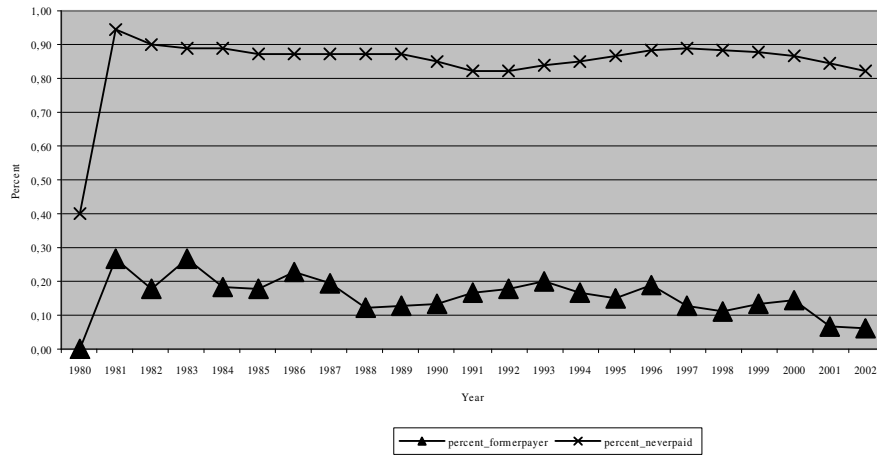
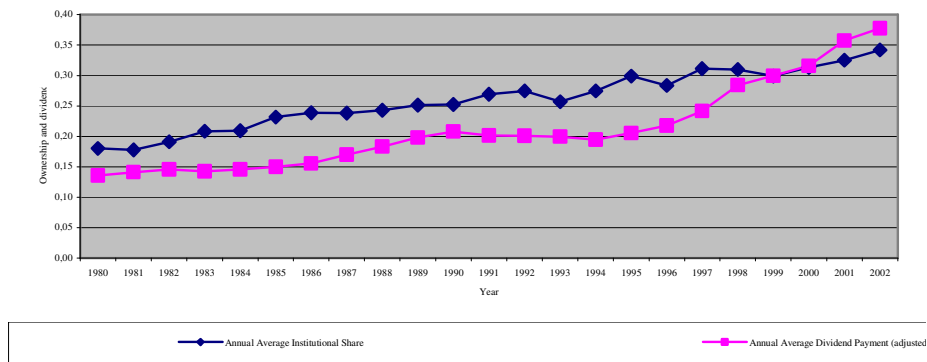


Figure 2. Institutional Ownership and Average Annual Dividend Amount 1980-2002



PECULIARITIES OF PRIVATIZATION AND CORPORATE CONTROL IN LITHUANIA

Jolanta Solnyskiniene*

Abstract

The article analyzes how ownership structure influences enterprise activity effectiveness, and topicality. The test results about the change of the structure of the stock capital in Lithuanian joint-stock companies during the period of 1999-2003 as well as the change of the effectiveness/results of the enterprise activity depending on the ownership constellation of the control block of the shares were given. Peculiarities of the cooperative management were analyzed.

Keywords: privatization, corporate control, Lithuania

* *Doctor of Social Sciences (Management and Administration), Ass. Professor, Department of Management, Economics and Management Faculty, KTU*

Laisvės al., 55, Kaunas, Lithuania

Tel. 370 (37) 323683

e-mail: jolanta.solnyskiniene@ktu.lt

Introduction

The problem of ownership and its effectiveness has become an object of scientific and practical argumentation much earlier than economics theory has arisen as a separate field of science. Ownership was and is the object of research in law, philosophy, economics, and institutional economics. Economic content of this category has been constantly supplemented. Ownership defined not only object dependence on a certain subject, but the whole spectrum of ownership and traditional relationships among people, groups and communities with respect to any object of the material world. The problem of ownership management effectiveness is an exceptional one.

Lithuanian researchers and foreign scientists have investigated the problem of ownership management, control effectiveness and corporate management. They have produced a number of arguments and maintained that ownership structure influences the indicators of enterprise effectiveness (Starkus, 2001; Gronskas, 1995; Balcerowicz, 1998; Berley & Means, 1932; Earle, 1998; Hansmann, 1996; Ross, 1973; Hill & Jones, 1992)

Privatization has preconditioned the primary property structure and the distinctions of corporate management system in Eastern and Central Europe countries (ECE).

Transformation processes in Eastern and Central Europe have become a specific object of scientific cognition and research. However, economics research renders different view to the relationship between

ownership structure and enterprise effectiveness, and not enough attention has been allotted to the uniqueness of conditions under which the changes in ownership structure have been and still are taking place. The number of works in this field manifests the fact that these problems are not widely dealt with.

Changes in Eastern and Central Europe countries have become an object of wider research. However, these investigations are based on different view towards ownership structure and enterprise effectiveness. One might notice that too little attention is paid to the analysis of circumstances which have made influence on ownership structure and different processes related to it.

The issue dealt with in the article could be phrased in precise terms: there existing no exhaustible research of how ownership factors influence enterprise activity effectiveness in Lithuania, it is expedient to present theoretical and practical considerations about the relationship between enterprise effectiveness and property structure emphasizing the factors and the consequences of institutional change - privatization.

Research object: ownership structure, activity effectiveness and corporate management system in Lithuania.

Research aims: to highlight the influence of ownership structure on effectiveness indices in Lithuanian companies; to generalize corporate management practice.

Research methods: the methods of monograph, comparative analysis, logics analysis and synthesis, graphical presentation, empirical research.

Property structure, the behavior of economy subjects and enterprise activity effectiveness

Both traditional and ownership relationships between subjects in micro-level are closely connected with the development of the system of political economics. Eastern and Central Europe countries have faced the phenomenon of political economics and its transformation. Although the phenomenon of post-communist transformation has not been fully investigated, it is obvious that the laws and regulations functioning in a mature market have no effect or act only partially while economic theories and doctrines are not able to explain transformation phenomena. The ownership structure and the transformation of the ownership rights in these countries became the specific object of the scientific knowledge and investigation.

Scientific discussions on effectiveness often keep to the approach that socialism is economically ineffective and the prevalence of state ownership in economy means "more socialism", vicious property structure, closed business regime and the mechanism of ineffective economy coordination (Balcerowicz, 1998, p. 27-99). It is maintained that the activity of state enterprises is bureaucratic economy subjects are not initiative (Mises, 1992), there are no risk-stimuli, their activity is not directed towards the introduction of cost reducing technologies (Hayek, 1935; Balcerowicz, 1998; Boycko, Shleifer and Vishny, 1994) and the leaders of socialist enterprises are not financially responsible for the consequences of ineffective management (Mises, 1935, p. 116-118; Kornai, 1990). Thus these countries have undergone the vast privatization of the state enterprises.

The state enterprise privatization has been the main chain in institutional reforms in ECE countries. Research works point out that the governments of ECE countries had to change the system, structure and regime of market economy as well as to consolidate property and property rights structure characteristic to economic countries (Andic, 1992; Balcerowicz, 1993; Boycko, Shleifer and Vishny, 1994; Šimėnas, 1996; Bornstein, 1994).

Taking a wider look at transformation phenomena, it is possible to maintain that the specificity of post-communist transformation conditions the fact that privatization in the countries of new democracy solved issues which had not arisen, to such an extent, to the countries of the market economy:

- property, income, influence and power distribution problems. Scientific literature presents a narrow aspect of this problem and deals only with the redistribution of property rights;

- the problems of the market institutions structure, consolidation of a social mechanism as well as the systematic and structural adaptation of economy to the changing environment.

Aspirations to limit the role of the state in ECE countries, has conditioned the way of privatization: it has remained massive from its very beginning. In 1991-2003 privatization principles and priorities essentially differed. They had crucial influence on property structural changes. This problem is emphasized in this article.

The issue of the relationship between ownership and enterprise effectiveness could be considered in several aspects:

- 1) the change of the structure of the ownership law;
- 2) ownership concentration level;
- 3) the constellation of dominating owners or real ownership control.

One more widely discussed problem in scientific literature is the type of organizations to be created, their ownership forms and influence on economic growth.

The specialists of the ownership law relate the effectiveness of contemporary enterprises with owners' behavior, different motives of their behavior and the opportunities of real ownership control.

The distribution right is mostly conditioned by an organizational form of economic activity: a personal enterprise, economic community, joint-stock company, company of limited-liability. Different ways of organizing economic activity determines the type of an owner constellation which can differ in its behavior, motives, stimuli, distribution.

Share ownership management is characterized by a number of distinctions.

First, shareholders possibility to directly manage ownership is limited because property interests are shared among many stockholders.

Berley & Means noticed that property and management / control functions in corporations are separated, however smaller shareholders cannot effectively control hired professionals' (managers') activity. On the contrary, the ownership is concentrated in the hands of one or a few shareholders, and they are empowered to control managers' activity, the latter sometimes being rather contradictory (Berley & Means, 1932).

Second, according to Hansmann, enterprise effectiveness depends on the owners' constellation controlling block of shares and the fact who is the owner of the control block of stocks. Agent theory views activity motives of share constellations and the control costs of hired managers at different aspects even in that case when they own equal share blocks (Hansmann, 1996).

Empirical research manifests differences that exist among enterprises based on dispersed or concentrated ownership structure: the higher share concentration, the more effective is the enterprise activity. Shareholders are given wider activity and control possibilities (Earle, 1998; Boycko, Shleifer and Vishny, 1994; Mygind, 2001).

Third, corporate management system registers and recognizes ineffective management cases at the

very beginning of their occurrence and reject ineffective enterprises (Aoki & Kim, 1995).

The following features characterize the scale of changes and the maturing of corporate management system:

- the proportion of physical and institutional owners in corporations;
- the market share of ownership service;
- the structure of different owners' constellations belonging to the same ownership category;
- the part of corporations managed by professional managers owing only a small part of property.

Scientific works dealing with ownership structure and enterprise effectiveness conclude that different types of owners influence corporate activity. Mygind writes that outsiders are better than corporate people, and managers are better than workers as well as foreigners are better than the country's investors.

This is because of different motivation, activity freedom, and financial possibilities in restructuring and modernizing enterprises, to say nothing of corporate management ability, experience, and other (Mygind, 2001, p. 479-480).

Table 1. Theoretical forecasts for different groups of owners. The main forecast: higher effectiveness

State	Employee	Manager	Foreigners
- information and incentive problems	- specific goals - lack of skills - capital shortage	- concentration risks - capital shortage	+ maximum profit increase + capital + management abilities + networks
+ soft incentives + benchmarking	+ motivation +profit equalizing + management control	+ strong managers' motivation	- culture - local networks
	- Specific obstacles in the country's market - Lack of an effective finance market		+ availability to well-functioning international markets

Note: + means 'plus'; - means 'minus'

Reference: Mygind (2001) Privatization, governance and enterprise restructuring in the Baltic rim – Paris; OECD.

Corporate management system

Corporate management system could be characterized as the entirety of institutional mechanisms that do not allow the occurrence of economy agents' behavior deviations reducing the firm's value in the market.

The transformation of institutional system in Eastern and Central Europe countries are still going on and there occur the interrelationship forms of institutional factors which are not characteristic to the developed market economy. As corporate management mechanisms are still in embryo stage or they do not work at all, capital concentration is one of the most effective and simplest ways for shareholders, striving to effectively control the enterprise activity. It is difficult and hardly possible to directly and

precisely measure the level of enterprise activity and property control. Factual level of property control could be evaluated by some indirect indications:

1) in accordance with the degree of property concentration;

2) in accordance with the structure of the constellations.

Striving to evaluate the influence of property concentration factor on property management effectiveness, it is possible to group enterprises according to the block of stocks managed by the biggest stockholders. Let's indicate the amount of stocks in the hands of the biggest stockholders with the letter A. It is possible to construct the following enterprise typology (Table 2):

Table 2. The influence of property concentration on the level of property control

	Concentration level					
	Very low	Low	Medium	High	Very high	Hyper high
The amount of the block of stocks	$A < 5$	$5 < A > 10$	$10 < A > 30$	$30 < A > 50$	$50 < A > 90$	$90 < A > 100$
Control level	Very low	Low	Medium	High	Very high	Hyper high

Analyzing the changes of the law of share corporations it is possible to notice that the shareholders' rights are closely connected with the number of shares possessed because shareholders

have influence on the enterprise management by voting at the general meeting of shareholders: one share gives one vote. Important decisions are taken by the absolute majority of votes: a hold of votes plus

one vote. The main issue is the majority of qualified votes, i.e., 2/3 or 4/5 of vote majority plus one vote. Foreign investors usually strive to hold the control share block because the bigger amount of shares ensures more rights. For example, if the number of managed shares comprises 1/2 of votes plus one vote (majority), a shareholder has the right to solve most questions unilaterally without taking into account the quorum of the general shareholders' meeting. Having

got the qualified majority of votes, he/she can make the decision to reorganize the corporation, to increase authorized capital stock, etc (www.lrs.lt).

Enterprises could be classified as follows:

- in terms of dominating proprietors' groups;
- according to the groups of the biggest stockholders.

The classification criteria of proprietors' groups may be different (See Table 3):

Table 3. The classification of proprietors' groups

1: Proprietors of the national origin		Proprietors of foreign origin		State	
2: Insiders:		Outsiders:		State	Others
<i>Managers</i>	<i>Employees</i>	<i>Non-financial outsiders:</i>	<i>Financial outsiders:</i>		
		- <i>Physical persons</i>	- <i>Banks</i>		
		- <i>Other means</i>	- <i>Investment funds</i>		
			- <i>Other companies</i>		
			- <i>Foreign investors</i>		
3: Physical persons		Juristic persons		State	

Not a single typology mentioned can precisely evaluate the influence of a concentration factor on the effectiveness of property control. This is the merely subject of the researchers' interpretations, based on the subjective experience, and attitudes.

Primary property structure of Lithuanian enterprises after privatization

The primary (cheque) privatization period could be considered as the beginning of the creation of property structure and corporate management system. The primary property structure has been mostly preconditioned by the three main factors:

- 1) the advantage of one privatization subjects against other ones in obtaining profit;
- 2) qualitative and quantitative characteristics of the profit privatized at different periods;
- 3) the development of legislative, institutional, investment, political, social-economic, micro-, macro-, mezzo- environment.

The development of enterprise effectiveness has not been the privatization priority. Privatization in 1991 – 1993/1995 was directed to the creation of a private sector, the consolidation of property institute and property rights. This period coincided with the statehood restoration and its strengthening. Surrounded by the euphoria of a "singing revolution", Lithuania, similarly as Estonia, Latvia, Russia, Hungary, Romania, has given priority to its own people: local investors, the employees of the privatized enterprises as well as enterprise managers had preference against foreigners.

Different interests of privatization groups have preconditioned the primary structure of privatized ownership in Lithuania:

- 52% of capital belonged to private, physical and juristic persons in the privatized economy sector (70.9% of economy objects) according to the ownership law (Šimėnas, 1996).

- the state owned 48% of capital in the privatized sector.

- the employees of privatized enterprises acquired 7.4% of the whole privatized property on favorable terms. 2/3 of this percentage was transferred to enterprise managers.

- joint-stock companies played a very important role. At the beginning of 1994 there were 379 of them and they owned 39% of the privatized property. 133 joint-stock companies possessing liquid ownership were registered.

- 0.0002% of ownership belonged to foreigners.

In Lithuania as compared to other Baltic states employees have been given fewer privileges in small than in large enterprise privatization.

Thus enterprise employees have acquired (usually under privileged conditions) the stocks of medium and large enterprises while the property of small enterprises has been supported by their leaders from the very beginning.

Shareholders were different in most Lithuanian companies until mid-1997 as compared to those of market-economy countries and most Eastern and Mid-European countries because a rather small fraction of share capital belonged to foreigners, the biggest part to the leaders of the highest level rather big part of the

state and a small one to the institutional investors (banks, investment funds, and others).

The research carried out by the Department of Lithuanian Statistics in 1996 shows that about 5% of companies are the owners of the capital of other countries (30%). Various enterprises have merged their capital with the capital of other enterprises in rather different ways. For example, retail enterprises work only on their own capital. Joint-stock enterprises face much more difficulties in selling out their production or rendering services as compared with other enterprises. The enterprises which engage about 30% of capital from other enterprises are not so successful in attracting foreign capital (Lietuvos įmonės...1996, p.56).

Having transformed state enterprises into share companies, there appeared groups with different interests: the state as a shareholder, enterprise leaders as shareholders, big and small shareholders, local and foreign investors, etc.

According to Agent theory, various groups of shareholders represent different interests: common shareholders expect dividends and the increasing share value in the market; the state strives to preserve its influence on consolidation of working places and (hopes to cooperate with governmental institutions; creditors, banks and others) except ownership liquidity and risk reduction, foreign investors look for new markets and "cream skimming", etc (Ross, 1973; Hill & Jones, 1992). In 1990 – 1996 there was no *corporate management experience* and the *legislative practice* of such management was not yet regulated, therefore company managers represented their own but not shareholders, interests.

The period of 1990 – 1996/1998 could be considered as the time of total ineffectiveness in all Eastern and Central European countries. The differences in the effectiveness of already privatized enterprises and those awaiting for privatization or not yet privatized might be maintained as merely random occurrences which do not express the essence of the whole process. At the time of capital and influence redistribution enterprise effectiveness was not a priority neither for the enterprise managers nor privatization agencies. The solution of financial problems of new democracy countries called for funds, therefore, privatization agencies were interested only in privatization scale and enterprise managers were waiting for the opportunity to take over the enterprise property and its management. There was no finance for production development (Lietuvos įmonės ...,1996, p.71); new managers had insufficient competence and experience.

Secondary ownership structure in Lithuanian enterprises

Having in mind the fact that the ownership structure of primary privatization could hardly conform to the long-term expectations of different owners constellations and become the most effective

ownership distribution form, as it has been proved by the world experience, secondary privatization, trade in shares and property could be considered very important because most of new owners are not satisfied with the amount of a share block or investment portfolio.

Trading in the shares of privatized enterprises is rather slack because of the underdeveloped market of securities / capital, financial-credit system, slow bankruptcy and ownership legislation procedures, bureaucracy, nepotism, corruption and other factors in the countries of transitional economy (Vilniaus bankas, 2004).

In all East and Central Europe countries, especially in Lithuania, Poland, Russia, Romania, Bulgaria the ownership structure changes in the private sector are not significant from the point of view of different owners' constellations. Scientific works dealing with ownership structure changes emphasize the tendency of transferring a considerable part of property to the managers. This trend to reuse employees' ownership is also noticed in a "personal level in enterprises".

Long-lasting privatization (primary and secondary) should be linked with constant and considerable changes in the structure of share ownership in Eastern and Central European countries.

The research of ownership structure in Lithuanian enterprises. Basing on the data of the state ownership fund privatized and being privatized enterprises, the analysis of the structure of Lithuanian ownership has been carried out. There have been investigated 1100 enterprises / share corporations, close corporations, state companies). According to the requirements of research validity, the research is representative and can reflect general transformation tendencies in ownership structure when the possible error of calculation is 5%. In social sciences a standard error is 5% obtained with 0.95 probability (Paniott, 1986).

The research has revealed that in already privatized and being privatized enterprises stock capital has been accumulated in the hands of the state – 10.37%, physical persons – 50.11%, juristic persons – 39.52%.

Figure 1 presents the research results of about dominating owners and ownership concentration level.

The research has shown that the share block of most Lithuanian enterprises is distributed among a number of owner constellations. The parts of the share block managed by physical, juristic persons and the state are rather small, most shareholders possessing not more than 30% of the block. Even 63.79% of physical persons manage 1-5% of the share block. 68.3% of juristic persons hold such part of the block of shares.

The state is the leader among big shareholders managing 90-100% parts of the block (2.09%). Now the state manages either the share blocks of big enterprises of the "remainder" of the shares in already privatized corporations. In most cases (79.16%) share

blocks amount to not more than 30%. It should be mentioned that in almost 37.5% of cases the state holds stock blocks which amount to 10-30%.

In order to find out how effectively shareholders can participate in corporate management and how

they can influence corporate activity, the amount of share block of a big shareholder has been investigated.

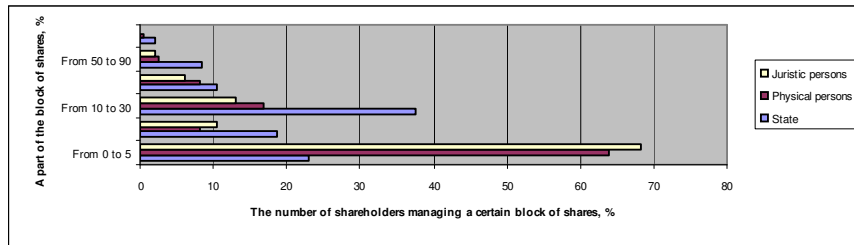


Figure 1. Factual ownership concentration in privatized enterprises in 2002

It has been proved that the biggest share blocks are managed by the state and institutional investors, respectively, 38.46% and 33.33% of the biggest

enterprise shareholders held 50-90% of share blocks. Even 30.77% of juristic persons were the biggest investors managing 40-50% of share blocks.

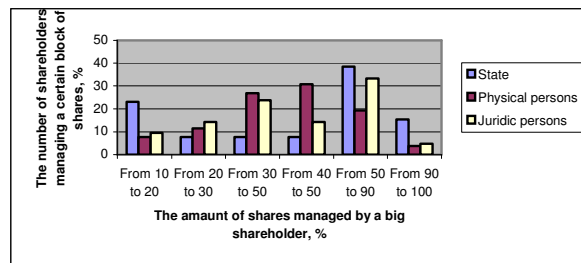


Figure 2. Distribution of share ownership in privatized enterprises managed by a big shareholders and differed in the amount of block of shares (2002)

As share blocks are distributed, the biggest shareholders usually have no control block. This makes ownership management rather difficult. Furthermore, shareholders find it rather complicated to control their ownership and managers' activity.

It has been found out that much profit is concentrated in the hands of enterprise managers. This witnesses the fact that ownership is not separated from management. An assumption could be made that leaders represent their own interests but not shareholders', especially the small ones. There is much less privatized property concentrated in the hands of leaders and other employees than, for example, in Russia where according to some sources in 1998 almost 16-22% of shares belonged to the highest level managers and 35-44% of shares to employees (Radigin, 1998; Kapeliušnikov, 2001).

In 1998-2003 there became evident one more tendency which influenced profit structural changes. Lithuanian economy subjects concentrate capital and increase the amount of managed stocks by means of the second privatization methods merging through horizontal and vertical combinations as well as applying activity diversification principles.

Demsetz (1997) distinguishes three competition types: competition by price, competition by higher quality and competition by quantity. Only big enterprises can compete by quantity. Both local and foreign investors increase effectiveness indicators of enterprise activity by concentrating capital and using scale economy effect for the increase of economic power.

Having analyzed the indices of the enterprises of different scales and activities, it has been found that:

1. The largest range of sales and efficiency level is achieved by the biggest stock and close stock companies after uniting into groups.
2. Enterprises-monopolies dominate among the most profitable and efficient companies.

The following companies prevail according to their sales and services: close stock companies – 65.35%, stock companies – 24.59%, personal companies – 2.33%. This phenomenon could be explained as follows according to the law of stock company modification (2003 12 11, No IX-1889) the number of stockholders in close stock company should not exceed 250. The stockholders can be both physical and juristic persons. This allows to accumulate property in the hands of fewer

stockholders and to avoid the limitations of capital concentration according to the competition law. However, due to the very complicated practice of close stock company investments to the other close stock company, stockholders lose the real possibility to control enterprise management activity and property.

Figure 3 represents the data of the work efficiency of the largest groups of Lithuanian companies. These results are almost the same as those of the biggest stock companies (Figure 4), e.g. the

work efficiency of Hanner group corporation is 1493.71 thousand Litass, joint-stock company “Mažeikiai Oil” - 1345 thousand Litass, Silberaut group - 874.07 thousand Litass, and Delta group - 807.89 thousand Litass, and joint-stock company “Lithuanian Energy” - 929.41 thousand Litass, the joint-stock corporation “Achema” - 426.64 thousand Litass, etc. per worker. In most of other enterprises work efficiency is less and equals to about 100-300 Litass per worker.

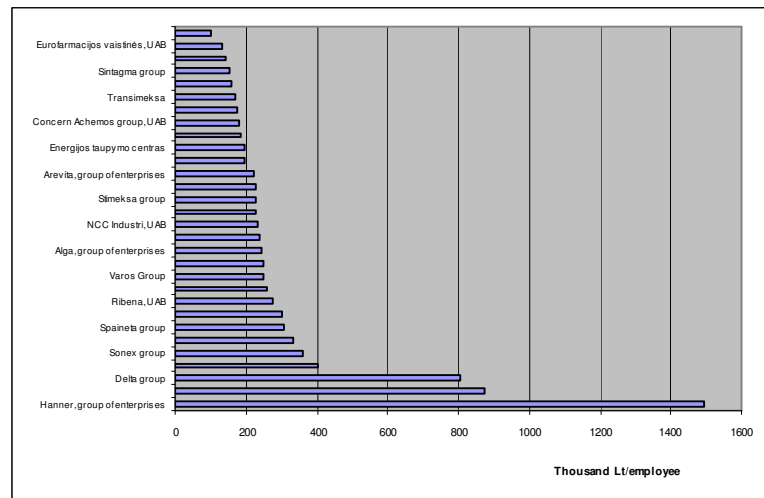


Figure 3. The work efficiency of enterprise groups

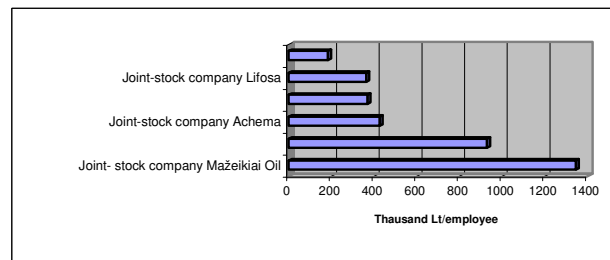


Figure 4. The work efficiency of the biggest Lithuanian joint-stock companies

Lithuania is different from other Baltic States in the formation of big national corporations or groups of enterprises: “VP Market”, “Achema group”, “Western Distributing Networks”, “Alita”, etc.

Lithuanian investors have acquired a number of share blocks in various corporations: “Orthopedic Technique”, “Panevėžys Aviation”, “Šilunga”, “Ventus Oil”, “Klaidėpa Smeltė”, “Vilnius Milk”, “Danga” and others.

The role of foreign investors in the process of property structure change

Privatization is a very important means of attracting foreign investments. During privatization foreigners become the owners of the state capital.

Scientific works analyzing the influence of property structure on enterprise activity effectiveness draw a general conclusion that various proprietors produce different influence on the enterprise effectiveness; foreigners are better investors than the local ones. It is maintained that local investors (the state enterprise managers, employees, physical and juristic persons) can have aims which are not related to the aspirations of maximum profit, e.g. higher wages, dividends, etc.

On the contrary the foreign investors strive to restructure and modernize privatized enterprises; they possess better financial opportunities, management skills including corporate management and the access to international business networks and markets.

In different ECE countries foreigners have had lesser or greater influence on property structure changes in stock companies. The amount of capital acquired by foreigners during privatization has been preconditioned by some causes:

- scale difference and quality characteristics of privatized property;
- attitudes to foreigners participation in privatization;
- the stage of transformation processes development influencing privatization.

Foreign investors have been and still are interested in big, more often infrastructural objects. The biggest infrastructural and energy enterprises have fallen into the hands of foreign investors in Estonia, Latvia, Czech, Hungary and other ECE countries. Since the very beginning of privatization in 1994 in Estonia, Latvia the amount of the foreign capital was constantly increasing and in 1998 in both countries it comprised approximately one third of the whole privatization turnover (Mygind, 1999). *The foreign investors overtake the biggest and the most profitable Eastern and Mid-European markets practically without any limitations.*

The scale difference of the direct foreign investments can be also related with the various investment surroundings in the country, i.e. the restrictions from the point of view of export of property, capital and profit, let alone tax privileges, etc. Foreign investors were apt to amply invest in Hungary, Czech republic, Poland and less in Romania. Other East European countries including Albania, Estonia, Latvia and Lithuania have been chosen less often. It can be considered that in Lithuania the investment possibilities were less favorable until the middle of 1997 than in neighboring countries Estonia and Latvia, and still far less favorable than in, for example, Hungary and Czech republic. Why?

In spite of the fact that Lithuania used the greatest tax privileges, the investment restrictions were also used. The most important are as follows:

- 1) the list of non-privatized objects has been made;
- 2) about 10-20% of the state capital has been allowed to privatize in the strategic state objects, and in the privatized big infrastructural and production enterprises the share in the authorized capital has exceeded the amount of 50%.

3) Foreigners were not allowed to buy the land.

Besides in 1991-1995/1996 foreign investors were not interested in Lithuanian enterprises that were on the privatization lists. Only four enterprises have been privatized by the foreigners until the end of 1995.

The privatization rules and priorities have changed with the end of privatization. In 1996 – 2003 privatization transactions have been signed under the principle of the “highest price”, provided that the foreign strategic investor will use the remaining aspects of the advantages.

Foreign investors are interested in bigger and monopolistic corporations.

The foreign investors have acquired the control block of stocks in the following joint-stock companies “Lithuanian Telecom”, “Klaipėda Ship Maintenance Dock”, “Lithuanian Insurance”, “Šilutės Peat”, “Geonafta”, etc. For example, most foreign investments have been attracted by the biggest enterprises in 2001-2003: “Lithuanian Telecom”, “Danisco Sugar”, “Klaipėda Oil”, “Lithuanian Gas”.

The investment practice of foreign investors could not be estimated unambiguously.

As the result of the privileges given to foreigners the biggest enterprises and their markets have been lost and the private foreign investors have been supported by the state means. For example, joint-stock company “Mažeikiai Oil”, “Lithuanian Energy” - the energetic enterprises directly supported by the state independent on the structure of the stock capital.

In the state investment plan of 1999 the share belonging to “Mažeikiai Oil” approximated to 45%, in 2000 – 79%. Up to 29% in 1999 and 4% in 2000 of all the loans acquired on behalf of the state (that had to be returned by the economic subjects), and 27% in 1999 and 17% in 2000 of all the credits taken with the state guarantee, comprised the loans to joint-stock company “Mažeikiai Oil”. On 29th of October, 1999 “Mažeikiai Oil” shares (33%) have been acquired by the USA company “Williams International”. This company also took the control of the company management.

The means of the privatization fund allotted to the state investments comprised only 9% in 1999-2000, and 16% of all the means in 2000.

The ratio of the privatized capital investments into the privatized objects during the period of 1996-2000 have been 0.24 million Litas after the privatization, or the average investment into the privatized enterprises approximated to 50 million Litas.

During this period 29000 work places were retained or newly issued, i.e. in 2000 the number of redundant employees was respectively by 1.03 times greater and in 2001 the number of redundant employees was already 1.28 times greater in the bankrupt enterprises, if compared with period of 1996-2000.

Conclusions

1. As the share blocks have been dispersed the biggest shareholders most often have no control block of the stocks. This brings difficulties into the management of enterprise property and makes the control of the enterprise managers complicated for other shareholders.
2. The distinctions of the corporative management have also been highlighted. The corporate management system in the countries of transient economics is either immature or does not exist at all. The only possibility for the stockholders to

effectively control the property is the concentration of the stock capital. The period of 1998-2003 is characteristic of two tendencies which influence the changes in the ownership structure:

- Lithuanian economy subjects concentrate capital by increasing share amounts and applying secondary privatization methods as well as combining both horizontal and vertical diversification principles;
 - Foreign investors take over the biggest and most profitable Eastern and Central European markets practically without any restrictions.
 - Concentrating the capital and applying scale economy effect, both local and foreign investors increase their economic power and the effectiveness indicators of enterprise activities.
3. A very high concentration of foreign capital in the biggest Lithuanian corporations-monopolies makes it difficult to solve international problems. It reduces economic security and slackens the competitive positions of national economic subjects. All these factors will have much influence in competing for European markets. It is necessary and expedient to regulate the economic activities of some enterprises – monopolies, i.e. pricing, requirements for production and services, etc.
 4. Theoretical assumptions on the influence of ownership structure on enterprise effectiveness present the possibility to maintain that the tendencies of the ownership structure distribution in 1998-2003 are positive and ensure effectiveness growth in Lithuanian enterprises in the future.

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RESILIENCE: THE RESUMPTION OF SHAREHOLDER PRIMACY

*Alex Proimos**

Abstract

The once dominant and inconsiderate player in corporate governance, the shareholder, has faced increasing pressure from its rival stakeholders (creditors and the general public) and their agents (i.e. the management and directors) eager to unproportionately increase their stake. The idea of shareholder primacy in corporate governance is while previously was losing its dominance as corporate law versus stakeholder theory could be set for an even stronger come back.

Keywords: corporate governance, shareholders, stakeholders

* Associate Lecturer in Finance, Macquarie University
aproimos@efs.mq.edu.au

Introduction

The former monopoly shareholder model has been eroded with the introduction of increased corporate governance regulations. But can shareholder primacy return, only time will tell whether stakeholders are able to maintain their increasing presence. The aim of this paper is to delve into the intricacies of corporate governance issues prevalent today and evaluate if the concept of shareholder primacy can regain its dominance despite the assertion that to hold shareholder primacy as the cardinal rule in corporate governance is outmoded, outdated and in the least, undesirable. Although, a model such as the stakeholder theory maybe more germane in the business world of today we give two examples whereby shareholders are beginning to flex their muscles.

Part one of this paper will introduce the two theories in corporate business and expound the essential bases of each theory; part two will explore the implications of each model to corporate governance issues; part three will evaluate if indeed shareholder primacy is a catalyst for “good” corporate governance and financial performance; and part four investigates two recent examples surrounding the relative re-emergence in the prevalence of shareholder primacy.

1. Fundamental Underpinnings of the Shareholder and Stakeholder Models

The Shareholder Model and the Notion of Shareholder Primacy

In its illustrious beginnings, shareholder primacy was seen as not only the essential rule of modern business corporations but it was also regarded as the golden safeguard to corporate governance problems. Shareholder primacy as an adjunct of shareholder

theory, views shareholder interests as exclusive and above all others and mandates that management devote its energies to the advancement of shareholder interests. If pursuit of this objective conflicts with the interests of one or more of the non-shareholder constituencies, management is to disregard such competing considerations.ⁱ

The shareholder was elevated to the pinnacle of the corporate hierarchy as a consequence of the characterization of the business form as a purely private enterprise. Under this classification, the business exists for the profit of its owners.ⁱⁱ Shareholders are owners of the firm as they solely provide the capital for the firm, and as shareholders are the primary source of equity for the business, managers must carry out the will and interests of shareholders. Shareholder interests are treated as pre-eminent on the basis that they are the residual claimants and bear the greatest risk. As they receive most of the marginal gains and costs, shareholders have the greatest incentive to maximize the firm’s value, thus, it is efficient for the managers to pursue shareholder interests.

The right to vote follows this residual claim and effectively gives the shareholder the power and discretion to make all decisions in a company; including instating directors and managers.ⁱⁱⁱ The fact that shareholders vote managers and directors into office, leads to the proposition that managers have a duty to support the shareholders and their wishes. This right to vote exemplifies the notion of shareholders as ‘owners’ of the firm. Thus, as owners of the corporation, managers must act according to their wishes and only make decisions that align with the interests of the owners, that being those which increase the firm’s value.

The prioritization of shareholders has also been strengthened through the interpretation of the nature of the corporation in economic terms. This view was expounded by Fischel^{iv}, who stated that the firm is a

legal fiction and merely a legal market, which serves as a nexus of contracts for mutual benefit of the people within the firm. Within this classification, corporations do not have any moral or social obligations and only operate to serve the market. Under this model, the shareholder is prime as all other constituencies in the firm are able to protect themselves through contract, bargaining for better positions. Management is seen to stand in a fiduciary relationship with the owners of the firm; thus, it is efficient for managers to pursue shareholder goals.

The traditional shareholder theory has measured efficiency as its main determinant that the shareholder is prime and absolute. The efficiency rationale states that shareholder's incentives to increase the firm's value is efficient as it utilizes the factors of production and strives to maximize the satisfaction of human wants.^v

The Stakeholder Model and its Fight for Recognition

In a world where morality and social ethicacy is becoming more accepted and desired, we are slowly seeing the fist of corporate law loosening its grip on the principle of shareholder primacy. As with any established conception, there is always another notion that is diametrically divergent. The hailed savior to grace the corporate plane in non-shareholder's eyes was the proposition of the stakeholder model. The fundamentals of this theory starkly challenge the underpinnings of the shareholder model by demanding that the interests of *all* not just shareholders be considered, even if it reduces company wealth and profitability. Therefore, the importance of the bottom line is not pursued nor recognized in the stakeholder model, as such a chase would demean the positions of all those who take part in the corporation. The stakeholder model was quite revolutionary, redefining the parameters and scope of manager's duties to people with contact with the corporation. Within this theory is the placing of all constituencies, including shareholders on a level playing field. Under this model, managers are constrained by two responsibilities- to ensure the ethical rights of no stakeholder are violated and to balance the legitimate interests of the stakeholders when making decisions.^{vi}

Corporate governance is determined, executed and supported through the classification of the corporation as a public institution. Dodd^{vii} identifies the classification of the corporation as a very important element as the classification goes towards what type of model the business adopts. He identifies that the assumption of shareholder primacy is reliant on the fact that the corporation is classified as purely private. Stakeholder advocates passionately frame the corporation as public, upholding the traditional view that business exists to provide a social service to the community. This view has stemmed from the early phases of the corporation when the state's

involvement was in granting corporate charters and encouraging the attitude that business existed to further society's needs and goals.^{viii} What necessarily is derived from such a classification is the fact that companies are social entities, and are encouraged to instill a responsibility to society, thus elevating all interests alongside shareholder's interests.

Taking these notions further, the nature of the corporation has been characterized as a legal entity; a real being that is responsible for its actions and decisions. This concept has been depicted in Dallas's Power Model^{ix}, which was propositioned as a new model of corporate governance to challenge the traditional shareholder model. This model interprets the firm as an organic institution with its own internal structure and processes that impact on control of the firm.^x Firm behaviour is reliant on the fact that there are power coalitions that are comprised of groups of people in specific relationships to the firm and with each other.^{xi}

As it was shown under the shareholder model, the shareholder is supreme due to the acknowledgement of their sole capital investment and contribution into the firm. In contrast, the stakeholder model rebuts this perception and implores that other constituencies have just a real and valuable investment in the firm. Flynn^{xii} supports such a rebuttal stating that workers have more of an investment in the firm, as they have invested their entire productive career, it being valued higher than monetary contribution. Shareholders do not provide most of the risk capital, as there are abundant sources of capital available, such as debt and retained earnings as examples. Thus, workers have a greater and more moral claim to the firm's furtherance of their interests. He believes that shareholder's are merely investors and agrees with Berle and Means^{xiii} that the corporation has a separation of ownership and control and that there is no secure democracy. Shareholders are no longer necessary and their interests are no longer paramount.

2. Ramifications of the Shareholder and Stakeholder Models on Corporate Governance

Corporate governance is an amalgam of legal issues, theoretical concepts and key elements that dictate and define the boundaries of directors and managers duties and responsibilities within a company. The endeavor of corporate governance is to adhere to a balance between two competing aims; one is to allow managers and directors to run the company as they see fit and the other is to ensure their decision making is achieved within the framework of effective accountability to the company and its constituencies.^{xiv} The study of corporate governance is complex and at times, not at all translucent and thus is a pressing issue for corporate law theorists to tackle. The consequences for corporate governance and its precincts are different when looked through the lens of the shareholder model or the stakeholder

model, as observed by Dallas^{xv}. These ramifications will be looked at as follows.

Shareholder Primacy and Corporate Governance

The shareholder theory has been the traditional view adopted by managers and corporations as the essential discipline for a successful company. Supporters of the shareholder theory believe there is no question as to how to better the firm under this model, as with shareholder primacy taking the corporate reigns, governance within the business is quite clear-cut. Advocates of the shareholder model, such as Fischel^{xvi} believe that when classifying the corporation as a nexus of contracts, there is actually no apparent corporate governance question to be resolved. By defining the corporation under economic theory, shareholders interests will be executed by managers because of the nature of shareholders role as sole suppliers of capital within the corporation. Shareholders do not participate in the governance of the company, as it is not extremely beneficial to do so. The unique characteristic of the modern corporation is that it enables individuals who have wealth but lack managerial ability to invest while allowing managers with little personal wealth to run the business.^{xvii} If managers fail to follow shareholder interests, the shareholder simply and easily succumbs to portfolio theory, selling their shares on the market. As in Fischel's words "Because of this free rider problem, most shareholders lack incentives to expend resources to become informed in elections or wage proxy contests. If a shareholder is dissatisfied, the more logical course in most cases is simply to sell one's shares. To sell shares is the shareholders guarantee/safeguard that managers will act in their best interests".^{xviii} It can be said that Fischel's points are not as simple as what he puts forward and there are flaws to his contentions. The seemingly simple governance mechanism of share selling does not work in practice or reality. The proposition that managers will act in the shareholders interest merely due to a threat of share selling, is blatantly refuted by the attitude of an increasing number of high profile directors, whereby shareholders were objecting to various decisions made by the boards. Moreover, we see have seen directors stating obnoxiously in annual meetings that if investors were unhappy with the way the companies were run, they should simply sell their shares.^{xix} Obviously, the directors least concerned with the possibility that shareholders will just sell their shares are the ones with a high concentration of power within the corporation. Ultimately, this can pose great governance problems, as shareholders (the minority that vote) do not get a voice in how actions should be done.

As managers are only responsible to one group, that is the shareholders, the only corporate governance issue evident under shareholder theory is when managers do not follow shareholder wealth

maximization goals (a failure of their fiduciary duty). The consequence of such derogation will result in managers being ousted and/or disciplinary action taken against breach of fiduciary duties. However, as it will be seen, managers can circumvent these shareholder protections by manipulating and finding loopholes that work in their favour. It is contended that shareholder primacy does not prevent nor rectify corporate governance issues and so, is untenable as the cardinal rule in corporate governance.

To reiterate, shareholders have the right to vote when shares are purchased enabling an ability to call elections on short notice and oust the directors or managers for any or no reason. The fear of the market for corporate control in theory, effectively works to ensure managers and directors act as faithful agents to residual claimants. However, in practice, crafty managers are able to circumvent this mechanism through clever manipulations of proxy.^{xx} Managers rely on shareholder apathy and collective action problems to hold onto and keep themselves in office. Berle and Means have observed the watering down of shareholder voting rights and a diminishment of shareholder power as a result of this reliance on shareholder voting side effects.^{xxi} Thus, coupled with the notion of dispersed owners, diminishing shareholder voting rights incur shareholders' positions within the corporation to one of 'impotence'.^{xxii}

A strongly campaigned contestant to this collective action problem and dispersed ownership is the institutional investor. Rock's^{xxiii} piece diligently examines the advancement of the theory that institutional investors have both the incentive and the ability to constrain managers. As institutional investors can concentrate their stock to override such shareholder weaknesses, they are the better fit for the mould to discipline managers. Bainbridge^{xxiv} has highlighted the fact that institutional investors can remedy collective action problems and monitoring issues as they have more power to hold management accountable and to access information and they are more interested and likely to invest more resources into determining the value of management decisions. However, there are various criticisms with such a remedy of institutional investors that cannot be overlooked or accepted. Institutional investors are agents and logically, with agents come conflicts of interests and further agency costs. Rock notes that both money managers and outside directors lack significant economic incentives to protect shareholder's interests, with both facing significant disincentives.^{xxv} Hence, we are back at square one.

The decreasing importance of shareholders is further exemplified in Gordon's^{xxvi} piece where he notes the effect that dual class common stock has on the behaviour and actions of managers. Dual class stock effectively allows managers to gain voting power disproportionate to their investment or what they are entitled to. This aims to destroy shareholder-voting power and with the added results of shareholder apathy, collective action problems and the

free rider issue, managers are able to increase their ability to stay in office. This exploitation also decreases the risk of a hostile takeover, as the board would hold the majority of the votes needed to challenge such a bid. This effectively gives them a permanent and secure tenure of office and greater power in making decisions and keeping them alive in the company. The concept of shareholder primacy in the corporation is thus a fallacy, if existing in reality at all. It does not deter or control managers deviating from their duties, if anything; it enables greater scope for managers to revolt.

The shareholder primacy principle is actually a means of tug of war between shareholders and the directors and managers within the firm. It is a fracas between two groups vying to gain control of the corporation and in a corporate governance context, this is an undesirable process. This process of constant conflict creates intrigue about how business efficiency prevails within the corporation.

Stakeholder Protection and Corporate Governance

Next we investigate stakeholder theory juxtaposed against the shareholder model to exemplify the inadequacies of the notion of shareholder primacy and its place in corporate governance.

The stakeholder model purports to rectify and avoid corporate governance issues that the shareholder primacy principle creates, by taking into account all players within the firm and not elevating one group as supreme. Advocates of such a regime do not discount the value of shareholders at all; they simply bring them down to the same level playing field as all other constituencies. This enables a fairer, more equitable and efficient corporate model. The stakeholder model does not discount the shareholder as an important interest; rather it includes their interests in the communal, all encompassing ambit of the stakeholder model's arms. Authors such as Dodd support such an embrace, stating that if managers take into consideration the welfare of stakeholders, this will in the long run increase the profits of shareholders, thus shareholders should really promote stakeholder theory.^{xxvii}

The most acclaimed counterpoint to the remedy of managerial opportunism and in general, corporate governance is the communitarian movement illustrated by Millon^{xxviii}. Communitarians have challenged the shareholder primacy principle quite vehemently, their work focusing on the sociological and moral phenomenon of the corporation as a community. Communitarians view the corporation as adhering to the Gierken^{xxix} theory of fellowship rather than a legal fiction. This vision presents a new-grounded perception by establishing a rich foundation of mutual trust and interdependence rather than limiting it to the bare bones of actual contractual terms. Communitarians are concerned about the harm to non-shareholders that occurs due to managerial

adherence to shareholder primacy and believe that the inherent unequal bargaining power between constituencies within the firm leads to parties being manipulated and taken advantage of through managerial gain from information knowledge, greater capital acquisition and unforeseeable harm, i.e.- technology and innovation. Communitarians believe the answer to all of these issues requires an extension of the fiduciary duties of the board to all stakeholders, effectively creating managers duties as 'multi-fiduciary'.

However, Millon does find some criticism in this creation. By enabling managers to be accountable to all stakeholders, there will be conflicts with not only shareholders and non-shareholders but also between groups of non-shareholders. Also by increasing the number of constituencies the manager is accountable to, this approach increases agency costs, which will not be efficient or beneficial to the corporation as a whole. The greatest criticisms of the stakeholder theory are accountability issues. By blurring the beneficiaries of managerial responsibilities, management will be accountable to no one.^{xxx} Thus, instead of manipulating systems to advance shareholder interests as in the shareholder model, under this model, managers will look to dishonest means to further their *own* interests. Too much power invested in management will see managerial opportunism emerging to greater heights. This falls into line with Dallas' power model where the managers emerge as the dominant party in the coalition. Stakeholders would effectively have to petition managers to act in their favour. Nonetheless, the communitarian movement has aimed to cure this denigration by praising state intervention to enforce non-shareholder rights. Bainbridge^{xxxi} sees this as diluting personal liberties and autonomy.

Whatever the criticisms, the fundamentals of the communitarian movement are to be applauded. Albeit, the model does need reworking to apply in practice, it adequately addresses the need for a more specific examination of stakeholder protectionism and awareness.

3. Should Shareholder Primacy Be the Cardinal Rule?

So what is the answer? It has been established that shareholder primacy is undesirable in the business world of today. Shareholder primacy ignores the inherent problems of the separation of ownership and control within modern business and allows gateways for managers to manipulate their positions.^{xxxii} Managers will embrace whatever illegal and dishonest means to achieve the goal of maximising shareholder value and shareholder theory will support this as long as it maximises their value and profit. We are increasingly becoming more ethically aware and morally sensitive. What was once viewed as competitive business strategy, the facets of shareholder primacy is now seen as morally

reprehensible. Even shareholders are becoming aware of the dangers of giving too much power to directors and managers^{xxxiii}.

What is proposed in this paper is that corporations should consider the interests of all groups, as this leads to the ultimate corporate governance faux par-managerial opportunism. The principle of managers bowing to shareholder primacy has been established as a fallacy. It not only creates disarray between shareholders and managers but can also facilitate bad corporate practice. The stakeholder model has numerous proponents that are seen as not only desirable but workable in the modern business world of today. Consequently the corporation has a responsibility to address the needs of stakeholders juxtaposed to the requirements of shareholders. Nonetheless, while in theory the stakeholder model is highly worthy, in the reality of the modern business world, the shareholder's demise to obscurity is far from near, if anything it will demand and gain further intensity.

4. The Reemergence of Shareholder Primacy

Undoubtedly shareholders are ever striving for a bigger slice of corporate action. Research from the Economic Policy Institute finds that despite the continual news about fast rates of economic growth millions of workers are still struggling live within there means. They find that a disconnect between what aggregate gross domestic product (GDP) numbers are worker incomes as corporate profits soar while the growth in labor compensation (the paychecks that families live on) has been historically sluggish. For example, the labor compensation's share of total income growth previously averaged 75% now it only accounts for 40% of total income growth. Conversely, profits' share of total income growth that averaged 25% now accounts for 60% of income growth^{xxxiv}. Ultimately this is an example shareholder profits at the expense of other stakeholders.

Next we find a strong voice for restraint and control on management remuneration as the shareholders and the public are outraged over the

enormous paychecks that are now standard for people who run large corporations. With compensation packages routinely running into the tens of millions of dollars, and it has become common practice for a top executive to walk away with hundreds of millions of dollars for their service and often *bad* service at that. Consequently, there have been calls for the rules of corporate governance to be altered to require that compensation packages of top executives get the approval of shareholders at regular intervals. Also, unlike the standard practice for shareholder votes, in which management gets to count unreturned proxies as supporting their position, the vote on CEO pay should only count ballots that are actually returned - as in a real election^{xxxv}. These could assist in protecting (empowering) shareholders against abuses by insiders - the sort of abuses that we witness when incompetent CEOs get hundred-million-dollar compensation packages - and increasing corporate governance by requiring more accountability of the board of directors.

Finally, we find evidence from Australia that shareholders may be alongside creditors in deciding a failing company's fate following a decision by the High Court. In the High Court's *Sons of Gwalia* decision this year the court held that former shareholders of collapsed companies are given the same status as unsecured creditors if they successfully claim losses for shares bought on the basis of misleading or deceptive conduct by the company directors or management. Consequently, the expectation is that shareholders will become poised to flex their right to vote in creditors' meetings to block plans for company restructuring (and re-listing) in accordance with certain cash. At the end of the day, this new shareholder power comes at the expense of other stakeholders, namely the creditors who otherwise would get a return on the future company's profits once operations resume^{xxxvi}.

From history and the recent occurrences it appears evident that the resilience of the shareholder primacy has not yet met its match.

Endnotes

ⁱ D. Millon, "Communitarianism in Corporate Law: Foundations and Law Reform Strategies" in Lawrence E Mitchell, Ed, *Progressive Corporate Law* (Boulder: Westview, 1995).

ⁱⁱ E. M. Dodd, "For Whom are Corporate Managers Trustees?" (1932), 25, *Harvard Law Review*, pg. 1145.

ⁱⁱⁱ I. Ramsay (Ed), "Key Developments in Corporate Law and Trusts Law: Essays in Honour of Professor Harold Ford", LexisNexis Butterworths: Australia, 2002 pg.105.

^{iv} D.R Fischel, "The Corporate Governance Movement" (1982) 35 *Vanderbilt Law Review* pg.1259

^v L.L. Dallas, "Two Models of Corporate Governance: Beyond Berle and Means" (1988) 22 *University of Michigan Journal of Law Reform* pg.19

^{vi} H.J Smith, *The Shareholders vs. Stakeholder Debate*, 44 *Sloan Management Review* 85 (2003), pg. 86.

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^{viii} J. Hill, *Public Beginnings, Private Ends- Should Corporate Law Privilege the Interests of shareholders?* 9, *AJCL* 1 (1998), pg.1.

^{ix} L.L. Dallas, "Two Models of Corporate Governance: Beyond Berle and Means" (1988) 22 *University of Michigan Journal of Law Reform* pg.20

- ^x *ibid* at p.20
- ^{xi} *ibid* at p.21.
- ^{xii} J.L. Flynn, "Corporate Democracy: Nice Work If You Can Get It" in Ralph Nader and Mark J Green, eds, *Corporate Power in America* (Harmondsworth: Penguin, 1977)
- ^{xiii} A.A. Berle, Jr and G.C Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1933).
- ^{xiv} I. Ramsay, *op cit* at fn 3, pg. 133.
- ^{xv} L.L. Dallas, at pg 21.
- ^{xvi} *Op cit* at fn 4.
- ^{xvii} D. R. Fischel, *op cit* at fn 4, pg 18.
- ^{xviii} *Ibid* at pg. 19.
- ^{xix} Mr Murdoch's statement is featured in an article by J. Synnott, *Like it or sell shares, rules Murdoch*, *The Sun Herald*, 16 November 2003 at pg 24. Mr Mansfield's statement is featured in a report by K. Nicholas, *Long, Angry Grilling for Directors*, Business section: *The Weekend Australian Financial Review*, 15-16 November 2003 at pg 10.
- ^{xx} Berle and Means, *op cit* at fn 13, pg 35.
- ^{xxi} *ibid*
- ^{xxii} *ibid*
- ^{xxiii} E.B Rock, "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 *Georgetown Law Journal* pg.445.
- ^{xxiv} S. M. Bainbridge, "The Politics of Corporate Governance" (1995) 18 *Harvard Journal of Law and Public Policy* pg.671.
- ^{xxv} E.B Rock, "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 *Georgetown Law Journal* pg.445.
- ^{xxvi} J. N Gordon, "Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice" (1988) 76 *California Law Review* pg.1.
- ^{xxvii} A. B. Berle, "Corporate Powers as Powers in Trust" (1931) 44 *Harvard Law Review* pg.1049.
- ^{xxviii} D. Millon, *op cit* at fn 1.
- ^{xxix} A. Black, "Editor's Introduction" in Otto von Gierke, *Community in Historical Perspective* (Cambridge: Cambridge University Press, 1990)
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- ^{xxxi} S.M Bainbridge, "Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship" (1997) 82 *Cornell Law Review* pg. 856.
- ^{xxxii} J.J. Flynn, "Corporate Democracy: Nice Work If You Can Get It" in Ralph Nader and Mark J Green, eds, *Corporate Power in America* (Harmondsworth: Penguin, 1977)
- ^{xxxiii} As seen from the articles by J. Synnott, and K. Nicholas, *op cit* at fn 19.
- ^{xxxiv} http://www.epinet.org/content.cfm/webfeatures_snapshots_archive_12032003 (Accessed April 2nd 2007)
- ^{xxxv} http://www.truthout.org/docs_2006/041707C.shtml (Accessed April 2nd 2007)
- ^{xxxvi} The Sons of Gwalia decision is currently under review by the Corporations and Markets Advisory Body which is the Australian Government Advisory Body.

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