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Incentives to innovate in response to competition: The role of agency costs

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ABSTRACT

This paper investigates the role of managerial ownership and incentive payment as potential drivers of innovation decisions by firms and as shifters of the competition-innovation link in the Russian manufacturing industry, where poorly protected property rights and a path-dependent market structure (typical for many transition economies) lead to a variety of outcomes. We use recent survey-based microdata for nearly 2000 non-listed companies in Russia. Our results suggest that managerial ownership, which initially evolved as a means of protecting against and resisting dysfunctional institutions, may stimulate decisions to undertake R&D and risky product innovations. Further, managerial ownership and competition are complementary motivations for R&D and innovation. Incentive payment to hired managers is a positive commitment instrument but has no impact on the competition-innovation link.

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1. Introduction

The economic literature has established two important factors that largely explain the innovation performance of firms. The first is competition, which motivates firms (at least technologically advanced firms) to innovate in an escape-competition framework (Aghion and Howitt, 2009); the second is agency costs, which reduce incentives to innovate. The literature, however, provides little evidence on how agency costs interact with competitive pressure and whether agency problems moderate the impact of competition on innovation.

This question is important for firms in transition economies, which are reputed to have limited incentives to innovate, operate within path-dependent market structures and often report a weak or even negative impact of competition on performance. Their corporate governance structure is significantly influenced by the relatively weak institutional setting in which they operate (La Porta et al., 1999). As Iwasaki (2007) concluded in the literature review, firms in a weak institutional setting need more internal power than firms in developed countries in order to implement management strategies, control cash flow and prevent external attacks, including attacks from the government.

Using Russia as an example, this paper tries to explain what makes a mature firm in an emerging economy innovative from the perspective of agency costs and considers whether corporate governance changes the way innovation is influenced by competitive pressure. We investigate whether competition in the product market can act as a disciplining power when a

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firm has relatively good corporate governance, and hypothesize mutually reinforcing effects of competition and corporate governance on the likelihood of R&D spending and product and process innovation. The corporate governance systems that we address in this paper are managerial ownership, where the firm is managed by the controlling shareholder (as opposed to the case when the firm is led by a hired manager), and the use of incentive contracts for managers in order to reduce agency costs.

We use survey data of Russian manufacturing plants, mostly represented by non-listed public and private companies of all sizes, except the largest (above 10,000 employees). This offers an attractive empirical testing ground for a number of reasons. First, Russia has provided one of the most intriguing stories of technological regress, from the innovation frontier back to imitation. The failure of owners and managers to take the initiative in an environment of relatively weak competitive pressure may be part of the problem. Second, the existing Russian ownership and control structure is a legacy of the country's post-Soviet privatization. This legacy, as of today, may be described as follows: insider control schemes dominate; most shares of privately owned companies are not traded; access to information for outsiders remains difficult; and corporate governance institutions remain weak (Kuznetsov et al., 2008). In this context, R&D, innovation and long-run investments, which they require, are more vulnerable to managerial myopia or disloyalty than is the case in the less troubled environment of advanced economies.[1]

On the other hand, most observers report some improvement of Russia's corporate governance environment in recent years, together with an improvement of financial and ownership transparency (The World Bank, 2013). Empirical studies show advances in ownership dispersion during the 2000s, mainly because more firms went public, while competitive pressure in product markets and foreign entry increased (Dolgopyatova, 2014). This suggests an exogenously determined reduction of agency costs for companies.

Third, the survey data allow us to directly measure innovation input and output, the power of competitive pressure, and corporate governance features, enabling a detailed assessment of possible links. The findings may be relevant for other emerging economies with highly concentrated ownership, a significant share of privately owned mid-sized companies, and a relatively weak institutional setting.

Our paper makes several contributions to the literature. It claims that managerial ownership is associated with a higher likelihood of R&D and product innovation, while process innovations remain immune from agency cost effects. Moreover, managerial ownership strengthens the stimulating effects of competition on R&D and product innovation. Controlling managers have more incentive to innovate in response to competition than firms where ownership and control are fully separated. Managerial incentive pay is a weaker instrument for inducing commitment: it helps reduce agency costs and stimulates product innovation, but does not provide a more positive response to competition.

The paper is arranged as follows. In Section 2, we review the literature that inspired this study. Sections 3 and 4 preview the methodology and data employed. We present empirical findings in Section 5. The final section concludes.

2. Literature background

We are interested in two strands of the theoretical literature dealing with agency costs, innovation, and competition. The first concerns theories, first introduced by Jensen and Meckling (1976), explaining innovation performance by differences in firm organization and corporate structure within a principle-agent framework. The recent literature states that innovation is the result of a specific investment decision by a firm, and this decision is significantly shaped by the corporate governance system, which determines the innovation performance of firms through the mechanisms of resource allocation and profit distribution (see Belloc, 2012; for an overview of this literature).

Agency costs associated with innovation are likely to be high, because innovation projects are risky, unpredictable, long term and labor intensive (Holmström, 1989). The agency theory predicts that if corporate ownership and control are separated, innovation decisions may lead to tensions between owners and managers due to a conflict of interests. Managers maximize short-term gains and the safety of their position, and may not be interested in long-term investment in innovation. Moreover, information asymmetry allows managers to pursue self interest at the expense of the owner (Hart, 1983; Bertrand and Mullainathan, 2003; Schmidt, 1997). Therefore innovation, as a specific investment decision, is often impaired by opportunistic behavior on the part of a "lazy" or "career concerned" manager. Some papers report that this problem is more severe for firms in emerging economies, where managers with shareholdings in the company they manage often have more controlling power than managers with comparable shareholdings in developed countries (Claessens et al., 2000).

Agency theory predicts that a strengthening of corporate governance through high ownership concentration and insider control may reduce agency costs (Claessens and Djankov, 1999) and opportunistic behavior, since owners can monitor their managers and curtail their ability to use control for their own benefit. The controlling shareholder is better informed about the potential value of R&D and innovation decisions, and is more likely to invest in long-term strategic projects or, as Estrin (2002, p.106) put it, the prospects for firm inefficiency are lower under owner management than in state-owned or other privately owned firms because "owners have a direct incentive to keep a close eye on things". When assets, strategic

[1] The World Bank rates Russia's performance regarding shareholder rights and other corporate governance institutions as being on a level with emerging markets in East Asia and better than Latin America, though the capital market and the number of listed companies in Russia remain small compared with developed countries (The World Bank, 2013).

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