



Strategic managerial delegation and industrial policy competition in vertically-related markets



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ABSTRACT

In a successive duopoly in which all firms are private except the home upstream SOE, we show that if the SOE is less efficient than its foreign rival, the home managerial delegation policy will force the SOE to price below marginal cost; otherwise, it will resort to marginal cost pricing to force out its rival. Both upstream firms will not be pure profit maximizers and will compete in profit and sales. The home government will subsidize its downstream firm if the market is large or the foreign rival's output is small. The foreign government will always subsidize its downstream firm.

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1. Introduction

It is well documented that since the 1980s, many developed and developing countries have privatized their state-owned enterprises (SOEs). Nellis (1998) showed that from 1980 to 1991, roughly 6800 medium- and large-scale firms were privatized in non-transition economies; by contrast, close to 60,000 such companies were privatized in transition economies since their independence, including hundreds of thousands of small firms. However, Kurlantzick (2012) showed that from 2004 through 2009, 120 state-owned companies made their debut on the *Forbes* list of the world's largest corporations, while 250 private companies fell off the list. State companies now control about 90% of the world's oil and large percentages of other resources. A recent OECD study by Kowalski et al. (2013, p. 6) reported that, of the 2000 largest public companies in the world, 204 have significant government ownership and their sales are equivalent to approximately 6% of worldwide GDP. The SOEs continue to be significant players in the business world.

Firms that have not been privatized or are only partially privatized exhibit a number of special features that warrant further discussion. First, as shown in Christiansen (2011), those which remain as SOEs are strongly concentrated in a few strategic sectors. Around half (in value terms) of all SOEs in OECD countries are located in sectors such as transportation, telecommunications,

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power generation, finance, manufacturing, and other energy industries.¹ For example, South Korea's government has more than 70% ownership over some of these sectors. Wade (1990) detailed how Taiwan's SOEs were built after Japanese occupation ended in 1945. He stated that the state influence has concentrated on, but is not confined to, the relatively large-scale firms of the upstream industries. He further added that in the 1950s Taiwan's public enterprises dominated industries such as fuel, chemicals, mining, metal working, fertilizer, food processing, textiles, and utilities. In total, these industries accounted for over half of industrial production. A few notable industry examples deserve further mention. Established in 1971, China Steel became one of the largest SOEs in Taiwan by 1977. Since then, it has fostered the government's secondary import substitution policy and provided steel and basic metals to Taiwan's downstream industries such as machinery, metal products, automobile, and IT industries. Although it was subsequently privatized in 1995, the state still holds about 20% ownership. Another notable example is the Chinese Petroleum Corporation (CPC) which was founded in 1946. In 1968, CPC built a plant to supply ethylene to many downstream industries which made materials for plastic and synthetic fibers and rubber. The development of these industries was deemed vital for Taiwan's economic takeoff.

The second feature is that even with the existence of SOEs, foreign competition is still allowed. For example, Taiwan has allowed foreign imports, especially quality products from Japan. China Steel and other SOEs in Taiwan must compete against foreign suppliers in the domestic market. The imports of key inputs grew along with Taiwan's export expansion. Wade (1990) reported that imports in many sectors such as petroleum products, iron, steel, aluminum, and transport equipment actually increased relative to domestic supply. Debates on how the SOEs should price their products to domestic downstream firms became a heated political issue. In reality, these intermediate inputs are often priced below their costs and also below the prices observed in foreign countries.² Clearly, production costs are not the only factor in SOEs' pricing decisions.

The third feature relates to the managerial reform of SOEs. Christiansen (2011, p. 6) showed that roughly half of the SOEs in the OECD area are non-listed but fully incorporated enterprises and that there has been a growing trend to hire professional managers with incentive contracts to restructure the SOEs. For instance, the OECD (2010) presented its recent guidelines on SOE reform by considering the responsibilities of supervisory and management boards, remuneration, transparency, and financial reporting. In the emerging countries such as China, Shirley and Xu (2001) found that 103,000 performance contracts were used for manufacturing SOEs in 1994. However, it is still empirically ambiguous whether or not an SOE's performance can be improved by restructuring.

Lastly, the fourth feature is that, in addition to receiving low input prices from the upstream SOEs, many domestic downstream firms have also received separate government subsidies. For instance, as reported by the OECD (2010, p. 207) on subsidy measures, Taiwan's government offered many kinds of subsidies such as financial and tax credits, as well as duty and tax exemptions for electronic, information, automobiles, and machine tool industries.

Managerial delegation has received considerable attention in the literature. One strand of literature such as Vickers (1985); Fershtman and Judd (1987), and Sklivas (1987) considered managerial delegation in the private sector. These studies found that in a closed economy, managerial decisions based partly on non-profit considerations such as sales can be more profitable for the principals than decisions based solely on profit maximization. Das (1997) introduced managerial delegation into a private firm in an open economy. He showed that under quantity competition, the import tariff is lower with delegation than without; however, under price competition, the opposite is true.

Another strand of literature considered managerial delegation in the public sector. Barros (1995) introduced a model with asymmetric information on manager's efforts. She showed that with incentive contracts the social welfare is higher and the government should wholly own the public firm. White (2001) examined a mixed oligopoly model with strategic incentives in which a public firm competes with a number of private firms. He showed that Barros' results carry over to the case of complete information. When hiring of managers is endogenized, only private firms will hire managers. The public firm does not produce output though its virtual existence serves to force the private firms to produce more output than in a traditional private oligopoly. Chang (2007) showed that when a partially privatized SOE emphasizes national welfare more than profits, the SOE will devise a managerial contract that induces the manager to be more sales oriented; furthermore, if the domestic firm is fully nationalized, it will price its output below marginal cost.³ Bárcena-Ruiz (2009) examined a model in which a mixed Bertrand duopoly will opt for offering managerial delegation. Both strands of literature discussed above are concerned only with horizontal models.

Regarding the industrial policy, governments may use production subsidies to aid their firms. Although it may also use trade policies such as import tariffs on the foreign upstream and downstream firms, such practices, however, are generally not permitted by the WTO and are more likely to elicit retaliations. Industrial policies such as a production subsidy, on the other hand, are easier to implement than trade policies as they cause less foreign opposition. Subsidies are frequently observed in the real world. They may be the result of a government's predatory or strategic policy to help its firms grab market shares or fight for survival, or may also be the result of political lobbying or general developmental strategies. Domestic subsidies in various forms are more easily concealed or explicitly allowed by the WTO. In the Agreement on Subsidies and Countervailing Measures (SCM), the WTO defines "subsidy" as a financial contribution to confer a benefit on an enterprise or industry by the government or any public body of a member country. Financial contributions may be in the form of grants, loans, equity infusions, loan guarantees, fiscal incentives, provision and/or purchase of goods or services, etc. The Agreement also requires that a subsidy be specifically granted to an

¹ See Li, Liu, and Wang (2012) for a detailed description of China's state capitalism.

² Ho (1981, p. 1194) and Hofheinz and Calder (1982, p. 57) found that in 1980, the price of fuel oil in Taiwan was 66% lower than in Japan and 72% lower than in Korea.

³ Fjell and Pal (1996) in a horizontal model without managerial delegation showed that the public firm which competes against a number of foreign firms will sell at a price that is lower than its marginal cost.

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