Journal of Banking & Finance 37 (2013) 4073–4086

Contents lists available at ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

Stakeholder rights and economic performance: The profitability of nonprofits

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ARTICLE INFO

Article history:
Received 9 December 2012
Accepted 6 July 2013
Available online 17 July 2013

JEL classification:
G34
L33

Keywords:
Corporate governance
Stakeholders
Ownership
Nonprofits
Competition
Banks

ABSTRACT

This paper explores whether ownership matters in a fundamental sense by comparing the performance of stockholder-owned firms with the much less analyzed nonprofit firms. No stakeholder has residual cash flow rights in nonprofit firms, and the control rights are held by customers, employees, and community citizens. Accounting for differences in size and risk and comparing only firms in the same industry, we find that stockholder-owned firms do not outperform nonprofit firms. This result is consistent with the notin that the monitoring function of stockholders may be successfully replaced by other mechanisms. We find evidence that product market competition may play this role as a substitute monitoring mechanism.

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1. Introduction

The objective of the firm and the allocation of ownership rights among the firm's stakeholders are two related issues that attract considerable public attention. A common view in the United Kingdom and the United States is that firms should maximize profits, and that residual claimants should hold all the ownership rights (Macey and O'Hara, 2003). In contrast, conventional wisdom in Continental Europe, Japan, and Scandinavia is that firms should have multiple goals and allocate ownership rights to more stakeholder types than just the residual claimants (Allen et al., 2011).

Our paper addresses these issues empirically by exploring whether the allocation of ownership rights (i.e., control rights and residual cash flow rights) among the stakeholders matters for the firm's economic performance. We focus on nonprofits, which are firms where no stakeholder has both control (voting) rights and residual cash flow rights (Hansmann, 1996; Glaeser and Shleifer, 2001). Moreover, the diverse control structure of the nonprofits in our sample may make these firms operate under multiple objectives. This setting allows us to test the agency-inspired prediction that returns on capital invested in nonprofit firms will be lower than if the capital were invested in firms controlled by residual claimants (Jensen and Meckling, 1976). We find that this hypothesis is not supported by the data, we analyze the economic mechanisms that may be driving this result, and we conclude that a likely candidate is product market competition.

The empirical literature on stakeholder structure and economic performance is quite limited. Rather than comparing the performance of nonprofits with the performance of firms with residual claimants, existing research has analyzed extensively whether cross-sectional differences in ownership structure correlate with differences in performance (Becht et al., 2003). However, these studies compare only firms that have owners, that is, stakeholders who possess both components of the ownership right (Hansmann, 1996). Therefore, this literature leaves unanswered the more fundamental question of whether owners are critical in the first place. That question cannot be answered unless firms with owners are compared with firms that do not have owners.

By definition, a nonprofit has no owners. This is because by regulation, none of the firm's stakeholders can have both control rights and cash flow rights. Although called nonprofits, such firms can still earn a profit, but this profit cannot be distributed to stakeholders with control rights. Consequently, our empirical setting allows us to compare the economic performance of firms that have

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http://dx.doi.org/10.1016/j.jbankfin.2013.07.021

owners with the performance of firms that do not have owners. Based on this difference in control structure, one would expect that profit-maximizing behavior is more likely among the owned firms than among the ownerless firms.[1]

Understanding the governance qualities of nonprofits is also useful per se, because these firms play an important role in the economy. For instance, estimates from the United States in the 1990s show that nonprofits account for 64% of hospital care, 56% of day care for children, 20% of college and university education, and 10% of primary and secondary training (Hansmann, 1996, p. 227; Malani et al., 2003). In fact, contracting theory argues that the firm may not always be most efficiently controlled by its capital providers, but rather by other stakeholders like suppliers, customers, and employees. Such alternative allocations of control rights, including the case where no stakeholder has residual cash flow rights, are more efficient the stronger the firm's market power over the stakeholder in question, the more firm-specific the stakeholder's human capital, and the less symmetric the information between the contracting parties (Hansmann, 1996). To ensure a sufficient focus of the paper, however, we do not analyze why the observed organizational forms actually exist. Nevertheless, we do ensure a homogenous contracting environment by taking all sample firms from the same industry. Moreover, we try to control for potential endogeneity between performance and organizational form in the statistical tests.

We use firm-level data from the population of Norwegian banks, which differ widely in terms of how cash flow rights and control rights are distributed among the stakeholders. One firm type is the standard stock company. These firms are commercial banks, where stockholders have all the cash flow rights, and where stockholders control the board by their voting rights. In contrast, ownerless (nonprofit) banks have no stakeholder with residual cash flow rights, and the control rights are shared by the employees, customers, and community citizens. That is, nobody can claim such a firm's assets or cash flow once the fixed claimants have been paid off, and there is no equity owner around to discipline management. Finally, the sample contains a third firm type that is a mixture of the two pure types. All banks in our sample have equal access to the same, unsegmented product market and operate under the same regulatory regime. Hence, any two firms may choose to use the same technology, the same product mix, and to be faced with the same demand curves. Regardless of what they choose, they are exposed to identical regulatory constraints.

The power of our test is increased by this combination of high heterogeneity in stakeholder structure and low heterogeneity in contracting environment, market opportunities, and regulation. Suppose a necessary condition for economic success involves profit maximization as the behavioral norm and control by residual claimants as a governance mechanism. If such a relationship is true empirically, it should show up in the data as performance differences between firms that operate in the same environment, but that represent the largest possible difference regarding preferences and control rights among the stakeholders.

Specifically, the agency logic suggests that compared to firms controlled by stockholders, firms controlled by multiple stakeholders without residual claims may have a double handicap in terms of producing high returns on capital. Our basic hypothesis is that ownerless banks produce lower returns on capital than do commercial banks. This happens because the ownerless bank lacks residual claimants who monitor management, and because a possible concern for non-owner stakeholders may be costly. Correspondingly, we predict that the performance of the hybrid bank, which is partly owned and partly ownerless, is somewhere in between the two pure types. As will be clear shortly, however, this basic hypothesis ignores several other potential determinants of performance, such as the banking supervisor and product market competition. We will gradually modify the basic hypothesis to account for this wider set of performance determinants.

Our major finding is that owned banks do not outperform ownerless banks. Certainly, this result does not imply that stockholders produce no value beyond providing financing. However, our finding does suggest that the governance function of residual claimants may be successfully replaced by other mechanisms. That is, managers may be efficiently disciplined by substitutes for ownership. The three substitutes we consider are regulation, capital constraints, and product market competition. First, it may be argued that by overlooking all firms in our sample, the public banking supervisor has a monitoring function. However, the supervisor does not fill the governance role of stockholders. The supervisor's job is to limit the downside risk and to ensure bank survival rather than to encourage the highest possible risk-adjusted return.

Second, one may argue that because ownerless banks cannot raise equity, this implicit capital constraint makes ownerless banks less prone to agency-induced overinvestment. We do not find empirical support for this explanation. Neither do we find convincing support for the somewhat related idea that just like managers of ownerless banks, managers of owned banks are not monitored properly because the owned banks' residual claimants have too weak incentives and too little power to control what the bank is doing. If this were the case, one would indeed expect owned banks and ownerless banks to have similar performance for governance reasons.

The third potential substitute for the owners' monitoring role is the need to perform in competitive environments. Purroy and Salas (2000) show theoretically that weak competition between profit maximizing and nonprofit-maximizing firms may produce equilibria where the nonprofit maximizer indeed earns the highest profit. Hence, lack of competition rather than differences in stakeholder structure may explain why ownerless banks are not outperformed by owned banks.

However, it has been argued repeatedly and also shown theoretically that only efficient firms survive when competition is strong (Machlup, 1967; Schmidt, 1997). Giroud and Mueller (2010) and Giroud (2011) have recently given empirical support to this idea in a corporate governance context. They show in their sample of stockholder-owned firms that monitoring by stockholders and competition in the product market are substitute governance mechanisms. In particular, the authors find that governance quality matters for operating efficiency only in noncompetitive markets.

In our setting, which is more general by also including firms without owners, the corresponding argument would be that competition disciplines a firm regardless of its stakeholder structure. Therefore, ownerless firms will persist in competitive markets only if they perform as well as owned firms do. By disciplining all firms, competition mitigates the governance handicap of ownerless firms by forcing them to let high returns to capital be the primary goal. We find support for this interpretation of our major result, using firm-level data on the relationship between returns on capital and local competitive pressure in the product market.

We conclude that the observed relationship between stakeholder structure and economic performance is better understood when the agency logic is supplemented by the effect of

[1] Empirical tests of stakeholders' role in corporate governance have not focused on firms' return on capital invested, but rather on firm behavior as reflected in productive efficiency, pricing strategy, risk taking, cost minimization, and transition between organizational forms (Malani et al., 2003). With few exceptions (Crespi et al., 2004; Ostergaard et al., 2009), the analyzed firms have at least one stakeholder with both cash flow rights and voting rights, such as equity investors in regular stock companies, depositors in savings and loan associations (S&Ls), policyholders in insurance mutuals, and producers in cooperatives. Thus, all these firm types have owners.

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