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Journal of Banking & Finance 30 (2006) 2995–3015

Journal of BANKING & FINANCE

www.elsevier.com/locate/jbf

The influence of financial and legal institutions on firm size

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Available online 30 June 2006

Abstract

Theory does not predict an unambiguous relationship between a country's financial and legal institutions and firm size. Using data on the largest industrial firms for 44 countries, we find that firm size is positively related to financial intermediary development, the efficiency of the legal system and property rights protection. We do not find any evidence that firms are larger in order to internalize the functions of the banking system or to compensate for the general inefficiency of the legal system.
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JEL classification: G30; G10; O16; K40

Keywords: Financial development; Legal institutions; Firm size

1. Introduction

A rapidly growing literature, originating with La Porta et al. (1997, henceforth LLSV), has demonstrated the importance of the legal system and financial institutions for firms' financial decisions.[1] For the most part, this literature treats firm size as given. However, financial intermediaries and the legal system provide an alternative way of accomplishing some of the key functions that the firm accomplishes internally: the mobilization of resources for investment, the monitoring of performance, and resolution of conflicts

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[1] See LLSV (2000), Bekaert and Harvey (2003), and Beck and Levine (2005) for an overview of this literature.

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doi:10.1016/j.jbankfin.2006.05.006

among different parties. As a result, the optimal size of firms might also depend on the development of these institutions in each country. In this paper, we investigate empirically the relationship between firm size and financial and institutional development across countries.

The corporate finance literature suggests that financial and legal institutions could affect firm size in opposing ways. In countries with underdeveloped financial and legal systems, large firms' internal capital markets are likely to be more effective at allocating capital and monitoring individual investment projects than the public markets and financial institutions. Along these lines, Almeida and Wolfenzon (2005) provide a theoretical model of the relationship between the scope of firms and the level of investor protection in an economy and the allocative efficiency of public capital markets. Given the differences in relative efficiency, firms in countries with weak legal and financial systems may have an incentive to substitute internal capital markets for public markets. This substitution would suggest an inverse relationship between firm size and the development of a country's legal and financial institutions.

There may also be another opposing effect at work. Large firms are also subject to agency problems. Their size and complexity makes expropriation by firms' insiders difficult to monitor and control by outside investors. Thus, investors in large firms may require strong financial institutions and effective legal systems to control expropriation by corporate insiders. These considerations suggest that the optimal size of firms may be positively related to the quality of a country's financial and legal system. Thus, the relationship between firm size and institutional development is likely to depend on the relative importance of these two effects.

To test which of these opposing effects is dominant, we need to focus on a sample of firms that are able to choose their boundaries and determine their size without significant constraints. However, several papers in the literature suggest that in countries with less developed legal and financial systems, firms are constrained in their operation and growth by their ability to obtain external finance (Demirgüç-Kunt and Maksimovic, 1998; Rajan and Zingales, 1998; Beck et al., 2005). If firms are constrained in their ability to grow and reach their optimal size due to access issues, the above trade-offs would be blurred. For example, even if underdeveloped institutions make it optimal for a firm to substitute internal markets for public markets and thus become large, financing constraints may prevent it from growing to its optimal size. Recent research, however, has shown that there are differences across firms of different sizes in the extent to which they are growth-constrained. Schiffer and Weder (2001) and Beck et al. (2005, in press) show that larger firms not only report lower growth constraints, but that the effect of different obstacles is less growth constraining for large than for small firms. Thus, in this paper we focus on the largest listed firms across countries to minimize confounding our estimates of size with growth constraints.

We investigate empirically the relationship between firm size and the development of financial and legal institutions in 44 countries, using information from financial statements on up to 100 largest listed industrial firms in each country. We use sales in constant US dollars, averaged over the period 1988–2002, as our main indicator of firm size, with total assets and market capitalization as alternative size indicators. We include an array of firm-, industry- and country-level variables in our analysis to control for other factors that determine equilibrium firm size, such as technology, market size, human capital and economic development.

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