



# Are large headquarters unproductive?



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## ARTICLE INFO

### Article history:

Received 22 January 2015  
Received in revised form 30 July 2015  
Accepted 8 September 2015  
Available online 25 September 2015

### JEL classification:

D23  
L22  
L25  
M10

### Keywords:

Headquarters  
Centralization  
Decentralization  
ICT network  
TFP

## ABSTRACT

Headquarters play an important role in modern companies, but the downsizing of headquarters is often advocated as a way to improve organizational efficiency. Using a panel of Japanese companies for the period 2001–2011, this paper empirically analyzes the determinants of the size of headquarters functions and their relationship with productivity. The cross-sectional dispersion of the size of headquarters functions is very large even within an industry. The complication of businesses leads to smaller headquarters. Headquarters functions contribute positively to a company's TFP. Headquarters functions and ICT network have a complementary role for productivity.

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## 1. Introduction

Headquarters play an important role in modern companies. As the core service sector inside companies, headquarters conduct a wide range of highly strategic activities, including the choice of business areas, the decision to introduce new products and services, the adoption of investment projects, human resources management, and financial management. Headquarters functions are the indirect business units behind direct activities, such as production in the manufacturing sector and selling in wholesale and retail. Because the costs of headquarters functions are treated as the selling, general, and administrative (SG&A) expenses in the current accounting standards, reducing these indirect costs is often regarded as an effective measure to improve profitability and productivity. In particular, during economic downturns, SG&A expenses are likely to be the target of cost reductions. However, headquarters functions executed in the general affairs, personnel, and accounting departments are not simple routine tasks. Their quality and quantity may determine the excellence of managerial decision making and, as a result, companies' overall performance.<sup>1</sup>

Recent studies have made clear that intangible assets contribute significantly to the productivity of companies, industries, and the economy. In estimating the value of intangible assets, executives' salaries and bonuses are often used as a measure of investment in "organizational capital"—an element of intangible assets (e.g., [Corrado et al., 2009](#); [Fukao et al., 2009](#)). The

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<sup>1</sup> [Foss \(1997\)](#), for example, points out that headquarters, by exploiting economies of scope and other synergies and in building up internal capital markets, may "create the positive" rather than merely "avoid the negative."

relatively low level of executive compensation (e.g., [Goergen and Renneboog, 2011](#), for an international comparison of CEO compensation) and the relatively large headquarters size (e.g., [Collis et al., 2007](#)) of Japanese companies compared with the U.S. and European companies suggest that the workforce in headquarters and executives of Japanese companies participate in important managerial decision-making. If organizational capital contributes to the company performance, not only the costs for executives but also SG&A expenses related to headquarters functions that support senior executives can be regarded as part of intangible investments.

The optimal size of headquarters is closely related to the centralization and decentralization of decision making. The more that decision rights are delegated to separate business units such as individual factories and shops, the lighter the burden on the headquarters will be. In this sense, the size of headquarters functions can be regarded as a good proxy for the degree of centralization.<sup>2</sup> Many theoretical studies on the trade-off between centralization and decentralization of decision-making have been conducted. According to these studies, both centralization and decentralization have costs and benefits, and the optimal level of centralization depends on various company characteristics. In other words, large headquarters are not necessarily inefficient from a theoretical point of view.

The size of headquarters functions is also related to the impact of information and communications technology (ICT) on organizational structure, as the use of ICT may strengthen the advantage of centralization to headquarters through quick and efficient communications with business units and establishments within a company. Another aspect of ICT may promote decentralization to the individual units by superior information processing at the local level ([Bloom et al., 2013](#)). This paper addresses the relationship between the size of headquarters functions and the use of ICT.

International comparative studies have shown that Japanese companies are unique in their relatively large headquarters ([Collis et al., 2007](#)) and low degree of decentralization ([Bloom et al., 2010a, 2012](#)). A possible interpretation of these distinct characteristics is that under Japanese style management, with practices such as long-term employment and frequent rotation of employees operated by personnel affairs departments ([Aoki, 1990](#)), headquarters have strong control over individual business units and establishments. However, formal empirical studies on the headquarters of Japanese companies have been scarce in the economics literature.

Against these backgrounds, this paper, employing panel data from the Basic Survey of Japanese Business Structure and Activities (Ministry of Economy, Trade and Industry: METI) for the period 2001–2011, empirically analyzes the determinants on the size of headquarters functions and their relationship with total factor productivity (TFP). The novel contributions of this paper are as follows. First, while there are case studies and international comparisons in the business and management literature, econometric studies on headquarters have been limited and, in particular, studies on the relationship between headquarters functions and productivity are—to the best of our knowledge—almost nonexistent. Second, from the viewpoint of productivity studies on the service sector, past micro-level studies generally analyze companies or establishments classified in the service industry as analytical units. This paper contributes to the literature by focusing on the service sector inside companies and its relationship with TFP that has not previously been explored. Third, empirical studies on centralization/decentralization of decision making have progressed recently through collection of data using extensive interviews and manager surveys. However, these studies depend on discrete measures of respondents, and generally provide a cross-sectional analysis. This paper complements the previous literature by focusing on the size of headquarters functions—an objective and continuous measure of centralization. The availability of long-term panel data is also an advantage of using this measure as a proxy for centralization.

The major findings of this paper can be summarized as follows. First, the mean size of headquarters functions is stable during the sample period, but the cross-sectional dispersion of the size is very large even within an industry. Second, diversification of business activities and the number of establishments are negatively related to the size of headquarters functions, suggesting that the complication of businesses leads to decentralization of decision making. Third, there is some suggestive evidence that the adoption of information and communications technology (ICT) network inside a company reduces the size of headquarters functions, although the magnitude is small. Fourth, headquarters functions contribute positively to the total factor productivity (TFP) of the companies. This result is robust after accounting for a potential endogeneity in the size of headquarters functions. Finally, ICT network inside a company and headquarters functions have a complementary role for productivity.

The rest of this paper is structured as follows. Section 2 reviews the literature. Section 3 explains the method of analysis and the data used in this paper. Section 4 reports the descriptive findings on the size of headquarters functions followed by the results on the determinants of the size of headquarters functions. Section 5 presents the results regarding the relationship between the headquarters functions and productivity. Finally, Section 6 concludes with policy implications.

## 2. Theoretical background and literature review

In the field of management literature, companies' headquarters have attracted attention for a long time dating back to the discussion about the advantage of unitary (U-form) and multidivisional (M-form) organizations ([Chandler, 1962, 1991](#); [Williamson, 1975, 1985](#)). Since then, a large number of case studies on the organizational structure of big companies have

<sup>2</sup> [Acemoglu et al. \(2007\)](#), for example, measure the degree of decentralization as whether different units of the firm are organized into "profit centers." Our interpretation that the size of headquarters functions is a good proxy for centralization is similar to their idea.

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