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Economic growth and concentrated ownership in stock markets

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Abstract

This paper presents a theoretical framework to analyze the implications on economic growth of a stock market that grows but is not well-developed in other aspects (concentrated ownership, low liquidity, poor legal and judiciary systems, and credit constraints). Family firms are modeled as consisting of risk-averse owners concerned with keeping the control of their firms while deciding to go public. It is suggested that in this type of economies there may be a non-linear relationship between stock market size and economic growth and that, in particular, the formation of an equity market may retard economic growth when institutions are weak.
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1. Introduction

In the theoretical literature on the development of stock markets and economic growth, a positive link is traditionally presented between these two variables. In particular, three causal factors are commonly stressed as having a positive impact on efficiency or savings: increased liquidity, diversification, and improvements in corporate control. Yet the theoretical debate is far from settled since some authors also point out the negative sides of these three elements.

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The formation of an equity market is endogenized in the model presented in this paper to explain a non-linear relationship between market size and growth, and thus, it is able to explain why growth in the stock market might retard economic growth under certain institutional environment. It is argued that manager/owners might not be risk-taking enough so that despite the diversification allowed by acquiring shares in other companies, they may use low-return technologies that reduce the risk associated with large-scale production. Moreover, a larger capital formation may not offset the drop in economic growth due to the reduction in productivity since managers may become preoccupied with the acquisition of financial claims on existing projects to the detriment of the firms' aggregate savings.

In order to derive the previous results, the model incorporates concerns on the control of ownership and the existence of credit constraints as limits to the financial diversification of entrepreneurs. These constraints may induce the selection of a low-return technology as an alternative device for risk reduction. In addition, the model considers how capital allocation through the stock market,[1] particularly in secondary markets, may have the negative consequence of diverting firms' earnings away from internal capital formation.[2] Accordingly, the model implicitly considers institutional elements that characterize many emerging economies, namely, an inadequate legal and judiciary environment as well as social norms that inhibit the transparency of economic behavior.[3] These features tend to produce family firms with concentrated ownership, severe failures in financial markets that exacerbate the problem of credit rationing, and stock markets with liquidity problems that preclude hostile takeovers and hamper the informational content of prices.[4] In the model, no attempt is made to formalize the causal link between the institutional features and the stylized facts (control concerns, credit constraints, and price inefficiency); the latter are only taken exogenously to analyze the impact of firms going public on economic growth under the setting described above.[5]

[1] This abstracts from the positive benefits of stock markets. See, for instance, the theoretical model in Cho (1986) that asserts that capital markets achieve efficient resource allocation since they are not subject to adverse selection and moral hazard, as bank credit is.

[2] Different studies show that stock markets anomalies are more frequent and robust in emerging markets (see, for instance, Durham, 2000; Claessens, 1995), and thus the allocating capabilities of such markets is put into question.

[3] See La Porta et al. (1997) for the legal view on financial development, and De Jong and Semenov (2002) for the cultural view on stock market development.

[4] In recent years, formal theoretical models have shed some light on the workings and performance of family-firms; see, for instance, Caselli and Gennaioli (2003), Burkart et al. (2003), Chami (2001), and Bhattacharya and Ravikumar (2001). The first two papers emphasize family control due to institutional imperfections despite that outside managers might be more talented. The third paper deals with the possibility of reducing agency problems with altruism and the prospect of succession within the family boundaries. The latter paper analyses the influence of primary capital markets imperfections on the evolution of family businesses. The owners of these firms are characterized by a special business skill that is fixed through time. Leaving aside the debate on the merits of manager/owners, the model developed here combines the idea of family control, due to institutional shortcomings or social norms, with the concern for the owner's descendants inheriting the firm.

[5] Traditionally, one of the main concerns in the literature on ownership structure is the trade-off between managerial control and liquidity; see Bolton and Von Thadden (1998), Bhide (1993), Maug (1998), Shleifer and Vishny (1986). Nonetheless, Burkart et al. (1997) suggest that there is an additional trade-off between monitoring and allowing managerial discretion. Thus, the selection of a relatively low concentration of ownership acts as a commitment device that helps managers to have certain leeway to pursue their initiatives. In the model developed

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