Corporate Governance and the State

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Pick up any first-year textbook in economics – firms maximize profits.

Berle and Means (1932) document existence of a *separation of ownership and control.* Their main concern – managers essentially rob owners of the firm. Enron, WorldCom, Parmalat.

Separation of ownership from control potentially gives rise to a host of principal/agent problems.

I. Corporate Governance Problems in Private Sector Firms

Oliver Williamson (1963) on-the-job consumption – company jets, gourmet chefs in the executive dining room.

Managerial compensation (Bebchuk and Fried, 2004). In 2009, Lawrence J. Ellison, Oracle's CEO, highest paid executive in US – total compensation $557 million. Federal minimum wage $14.31 per hour, annual income $28,620, assuming 40 hour week, 50 weeks in the year. Ellison earned the equivalent of this annual salary in first 6 minutes he worked.

Steven Kaplan claims that managers have much higher incomes today, because they manage much larger companies.

Company size not exogenous – Baumol (1962, 1967) and Marris (1964).

I have argued that many mergers take place because managers are pursuing growth rather than shareholder value. Evidence – mergers come in waves correlated with stock prices; shareholders of acquiring companies suffer wealth losses over 2-5 years following the mergers.

Marginal *qs*- Estimates for roughly 700 large U.S. companies for the 1970s and 1980s revealed that 80% had marginal $q < 1$, mean q just over 0.7.

Europe – marginal q for Germany 0.57; Belgium 0.51, France 0.57; Italy and Switzerland 0.64. Austria, marginal $q = 0.71$!!

II. Corporate Governance Problems in State-Controlled Companies

Politicians, bureaucrats, social planners seek to advance the public interest, maximize a social welfare function?

William Niskanen (1971), bureaucrats strive to maximize their budgets.

3 principal/agent problems for state-controlled companies.

1. Citizens as principals, elected representatives as agents.

2. Elected representatives as principals, regulatory bureaucracies as agents.

3. Regulatory bureaucracies as principals, managers of state-controlled companies as agents.

Given the multiple levels of principal/agent problems in state-controlled companies, it is to be expected that they perform even worse than private sector firms.

Controversial, especially among political scientists – Leif Lewin (1991).

In *Public Choice III*, I surveyed 71 studies that compared costs of supplying various services – trash collection, airlines, schools. In 56, almost 80%, private firms were more efficient (lower cost) than the state enterprises. Only 5 concluded that state firms were *more* efficient.

Marginal *qs*	Family-controlled	State-controlled
Anglo-Saxon	1.08	1.01
Scandinavian	0.77	0.80
Germanic European	0.60	0.37
French	0.57	0.95

Conclusion.

Overinvestment by state-controlled companies is not a major problem outside of Austria, Germany and Switzerland.

III. Corporate Governance Problems in Regulated Industries

Firms operating in private sector are constrained by plethora of laws and regulations governing consumer protection, environmental protection, hiring and firing, and anti-competitive practices ....

Traditionally, “regulated industries” has meant industries that often have elements of natural monopoly. Central focus of regulation was prices charged by regulated companies.

Averch and Johnson (1962) argued that setting prices for regulated firms so as to guarantee a certain return on total assets induced the firms to adopt more capital intensive production techniques, *because these led to higher profits*.

But same 3 levels of principal/agent problems exist for regulated firms as for state-controlled companies.

Glaring example of regulatory failure in US in 1980s – Savings and Loan Associations (S&Ls).

Inflation leads to high interest rates. Ronald Reagan promises “to get government off the backs of citizens.” Congress obliges: S&Ls free to make riskier loans. S&L managers began financing construction of shopping malls and other high risk ventures. Depositors’ savings insured by federal government. Safeguards against bad loans not installed. Federal government picks up the tab – $50billion.

Behavior of S&L managers resembled that of empire-building managers who pursue growth through mergers.

In 1991, Lawrence White drew some “public policy lessons” from the “S&L debacle,” lessons he hoped would help lead to regulations in the banking and thrift sector, which would avoid a repeat of the debacle. The lessons were not learned.

During middle of 2000s, interest rates low, property values surging, financial institutions make huge profits by selling mortgage-backed securities and other high-risk securities. Five of biggest Wall Street financial companies request reduction in level of cash they were required to hold as a percentage of their loans outstanding. As in 1980s, occupant in White House business friendly, and regulation averse. Wall Street firms got their request. $50 billion cost of S&L debacle looks trivial in comparison with losses in recent financial crisis.

Actions by S&L managers in 1980s, and financial institution managers in 2000s illustrate principal/agent problems at level of the firm. George Stigler (1971) described an agency problem at level of the regulatory agency. Regulatory agencies often *captured* by companies they regulate.

U.S. airlines industry. Richard Posner (1975) estimated that the regulatory policies of the CAB raised airline ticket prices by 66 percent.

Other examples of price increase due to regulation:

Physicians’ services, 40%

Eyeglasses, 34%

Milk, 11%

Motor carriers, 62%

Oil industry, 65%

Third level principal/agent problems – legislatures, perhaps executive branch. If a regulated industry is heavily concentrated in a representative's district, this person has strong incentive to watch over it, first because it may employ people who might vote for the representative, second, because the regulated companies may contribute to representative's campaign for reelection. Here we have another example of capture, Weingast and Marshall (1988), Zingales (2012).

Looked at from one perspective, the kind of logrolling Congress engages it does not constitute a principal/agent *problem* as such. True principals congressmen serve are the interest groups, which supply them with votes and campaign contributions.

But public interest suffers.

Logrolling in the European Union.

EU differs from USA in one important respect. Any major policy initiative in the USA must be approved by Congress and the president. Such democratic accountability does not exist in the EU – competition policy.

Environmental policy. Amount of carbon in world's atmosphere rises relentlessly, as do predictions of future global temperatures. How can that be?

Main thrust of Europe's attack on global warming has been to promote alternatives to coal, oil, and gas, such as wind and solar power.

Expensive. 2004 UK study – cost of kilowatt hour of electricity produced by windmills on land 5.4 pence; windmills off shore 7.2 pence; using gas 2.2 pence, nuclear energy 2.3 pence.

Result – energy intensive industries in Europe uncompetitive internationally. Production migrates to China and India. From year 2000 through 2010 global demand for coal grew by over 70%; China and India accounted for more than 90% of this growth.

How could Europeans get it so wrong? Greens averse to weighing costs and benefits, or thinking about economic incentives. Additional factor – windmill and solar panel producers, wind farm operators, contractors installing solar panels, manufacturers of “smart” appliances benefit, indeed could not exist, without EU’s environmental regulations and subsidies.

Roughly half of operating costs of wind farms in Great Britain is covered by government subsidies, estimated at over £1 billion in 2009, projected to rise to £5 billion in 2020.

Through higher prices German consumers subsidize wind-generated electricity by over 14 billion euro per year.

Center piece of EU's efforts to limit carbon emissions – carbon cap and trade market. Commission printed too many carbon emission permits, and tried to correct this mistake by withdrawing some permits. April 16, 2013, European Parliament rejected that proposal.

As with EU competition policy, there has been no European-wide debate over whether a carbon cap and trade system was best way to reduce carbon emissions (carbon tax?). No elected governments have had to defend it, or defend generous number of carbon emission permits printed. Nor, for that matter, did the European Parliament have a mandate from the citizens to reject the Commission's proposal. Indeed, the European Parliament has no mandate at all.

In EU, both those making policy proposals (the Commission) and those modifying or rejecting them (Parliament) can do so largely free from worry about the consequences of their actions for their future careers. The severance between principals and agents is complete.

IV. Conclusions

Ideal worlds.

Real world – principal/agent problems.

Pivate sector, mainly between owners and managers, when ownership widely dispersed.

Europe – ownership is concentrated, large shareholders often work with managers to exploit minority shareholders.

Public sector, things are even worse.

Policy implications?

Constitutional changes.

United States. Abolish geographic representation. Constitutional amendment to allow Congress to get around First Amendment's protection of rights of interest groups to buy votes through their campaign contributions.

Won't happen.

Things are, if anything, worse in Europe – at least at the level of the European Union.

A decade ago EU had opportunity to eliminate or at least reduce "democratic deficit." It failed miserably.

Also had opportunity to decide whether EU should function as a *confederation* or a *federation.*

Confederation – eliminate the Parliament.

Federation – eliminate the Council.

Opportunity to rationalize and clarify what the EU is was totally missed. This failure was to be expected, given composition of convention that drafted new constitution. *All* interested parties represented – Commission, Parliament, and national assemblies. Preserving status quo was almost an inevitable outcome.

Future reforms?