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OWNERSHIP AND CONTROL STRUCTURES A CASE STUDY

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Abstract
This is a study on separation of ownership and control in Southeast Europe, and in particular it is a case study of Macedonia. For structured analysis of this case study we use the World Bank Microdata Library, specifically the Enterprise Surveys which contains firm-level data of a representative sample of economies private sectors.
What we are interested in are the ties of ownership and control and whether such linkages contribute to the development of domestic firms and the overall economy. Corporate governance systems and ownership structures are economic fundamentals which influence economic behavior and corporate performance. Market-oriented corporate systems and network-oriented corporate systems are novelty in much needed enterprise restructuring process due to economic transition.
This paper is a contribution to the research developing the business aspects of the Southeast Europe economy, as there is constant lack of scientific papers that deal with the specific issues of corporate governance and enterprise restructuring.
Keywords: Ownership, Control structure, Corporate Governance.

1. INTRODUCTION

The separation of ownership and control can date back to Adam Smith where it is clearly indicated that managers manage other people’s money and thus there needs to be ‘anxious vigilance’ on their work, because they tend to exercise ‘negligence and profusion’ (Smith 1776). Further, contemporary attention to this phenomena was given by the works on provate property and modern corporations by Berle and Means (Berle and Means 1932).

It is evident that when important decision agents do not have proportional relations of their decisions to wealth effects, incentive conflicts arise between owners (principals) and managers (agents). Thus, an agency problem occurs. This problem is caused by separation of ownership and control and has been subject to extensive research (Smith 1776; Berle and Means 1932; Blomström and Kokko 1998; Zhou, Li et al. 2002). More recently ownership and control have been examined through the prism of ownership structure and performance, more specifically takeovers and share stakes (Aitken, Harrison et al. 1996; Girma, Greenaway et al. 2001).

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Further, theoretical grounds were enriched with empirical studies linking ownership and legal environment, especially with investor protection (Balasubramanyam, Salisu et al. 1996; Conyon, Girma et al. 2002; Alfaro, Chanda et al. 2004). Also, there has been research on links between ownership and internal control which impacts executive performance (Dosi and Soete 1983; Hubert and Pain 2001). Control structures can be complex, thus it becomes trickier to recognize controlling investors and the leverages in majority voting (Conyon, Girma et al. 2002; Djankov and Murrell 2002).

2. OWNERSHIP AND CONTROL

Separation of ownership and control can be observed with reference to owner managed firm. In that case the owner and manager 1) makes management decisions and 2) has share of the profit (residual claims). On the other hand, in publically traded company the shareholders have residual claims; however lack direct control over the board, which is usually enforced through voting rights. Therefore, shareholders have limited rights to control the firm and are not allowed in day-to-day decision making. As shareholders have the right to elect the board of directors, they use so-called proxy control i.e. voting rights.

2.1. Separation of ownership and control as a source of the agency problem

The agency relationship is usually defined as a contract that defines the engagement of the agent to perform service on behalf of principle by delegation of authority (Smith 1776). Hence, such relationship occurs between shareholders and managers in a joint-stock company, which is usually taken as a classic example. On the other hand, if there is a case where the owner and the manager are one of the same, there is no agency problem. This problem has been much researched and many useful propositions have been given by the literature.

External and internal monitoring mechanisms can be used as bas for control. Consequently, external control takes place through couple of mechanisms including capital markets performance, shareholder block capacities and the takeover bids on the market. Alternatively, internal control can take shape throughout the integrity of the firm as monitoring of the levels of management and between managers, especially owing to the board of directors (Zhou, Li et al. 2002). It has been argued that most efficient and low cost mechanism is the board of directors as it is common denominator for all companies no matter the size. The board also needs outside members so that it can control discretionary decisions of top managers, and that is due to the fact that outside members have incentives to develop standings as

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experts to foster the reputation of the company. Indeed, board members of low performing companies are less likely to become board members of any other company (McGuckin and Nguyen 1995).

Ownership can be very different between joint-stock companies i.e. it can differ between two extreme options, that is, it can be concentrated in blocks of stocks in the hands of couple individuals or it can be widely dispersed among the workers and other stakeholders including the cases of parent-daughter formations.

2.2. The Benefits of the Separation of Ownership and Control

There are three main factors determining the benefits of separation of ownership and control: 1) in some circumstances hierarchical decision making has upper hand over market allocation, 2) optimal firm size is difficult to estimate mainly due to economies, hence decision making requires complexity, 3) changing market conditions impact investment strategy and boards are able to pool and diversify for better allocation of recourses.

Market structures and hierarchical structures impose transaction costs (costs suffered in making an economic exchange or the costs of participating in a market). When it is the case and if such costs are high, hierarchical decision making has better efficiency over market allocation (Williamson 1979). Large size of a firm combined with hierarchical organization can have advantage over other organizational forms in transactional and productive efficiencies by using separation of ownership and control. In such cases benefits that prevail over costs, especially agency costs and thus it is expected to have high level of separation of ownership and control (Arrow 1974; Fama and Jensen 1983).

2.3. The Cost of the Separation of Ownership and Control

The separation of ownership and control is typified as agency problem (Jensen and Meckling 1976). There is separation between principals and agents i.e. shareholders and managers respectively. Further, agents characterize with maximal personal utility function and principals aim for control over behavior in order to achieve profit. In such relationship inevitably there are costs, that is, costs of providing incentives to agents to get their goals in line with those of the principles. Therefore, the costs of separation of ownership are principal-agent costs: ‘the monitoring expenditures by shareholders, the bonding expenditures by managers and the residual loss from the divergence of behavior (even with monitoring and bonding) from the ideal’ (Bouckaert and De Geest 2000).

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The literature shows that agency analysis puts different utility functions of managers and usually opposed to those of their principals. So, agency analysis puts in place incentive schemes aimed at inclining managers' objectives to those of their principles, and such systems are based on control and reward performance. Nevertheless, there are some problems with this notion; specifically the compensation system and how it can be enforced as there are conflicting incentives. There are two concepts that indicate problems related to the separation of ownership and control. The first one is that there is no solid position that principles should have the ability to control, as it can undermine the benefits of the process. Second, it is not socially enviable for agents to act in the best interests of their current principals.

Further, in order to estimate costs of separation of ownership and control there are a number of steps incorporating communication of societal goals, approximation of managerial behavior in relation to those goals and formation of institutional arrangements in terms to lower the costs. It must be said that managerial behavior might not be in line with the ideal imposed because of two main reasons: 1) managerial incentives (a hazard problem) and 2) managerial ability (they could be incompetent), which is defined as adverse selection problem (Goergen, Mallin et al. 2010).

2.4. Mechanisms for Mitigating the Costs of the Separation of Ownership and Control

There are mechanisms for mitigating the costs of ownership and control as managers might be irrational and inefficient while pursuing their personal goals. These mechanisms are directed towards correction of behavioral incentives in order to conform agents' behavior to the goals of principles. Generally we can derive number of basic categories, which are to be explained below.

a) Business Failure

Business failure is one of the basic mechanisms that evidently shows incompetence and selects managers on bases of merit. It is well expected that business failure is serious constrain of moral hazard and severe correction to manager's behavior. When there are no other mechanisms of control, the market is a corrective force that rewards or fails firm management.

If managers are not able to commit their behavior to benefit residual claimants (principles), it is to be expected that the principles (shareholders) will not be inclined to further investments in development of the firm as they do not exercise direct control. Asymmetric information will result in elimination from the markets (Akerlof 1970).

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b) The Market for Corporate Control

When there is functional market for corporate control directors are strained to increase value, therefore increasing market share worth, otherwise they are faced with loss of their job. Such markets reduce the cost of separation of ownership and control because managers act upon market pressures albeit no direct control imposed by shareholders. The market for corporate control in this way is useful for mitigation of adverse selection and moral hazard (Baysinger and Butler 1985; Romano 1991; Daines and Jon 1992; Berndt and Gupta 2009).

Nevertheless, the market for corporate control has downside as a mechanism for mitigating the costs of the separation of ownership and control entangled with the efficient market hypothesis. Misbehavior of manager is to be restricted by takeover activity/threat, and in order this to be the case there has to be a correlation between incompetence and stock price (Stout 1988).

c) Corporate Governance Structure and Oversight

The corporate governance structure is comprised of relations, mechanisms and processes that are employed in the control of corporations; hence they single out the dissemination of rights and responsibilities among different participants. A very important function of corporate governance is direction of the company, and having decision making structure includes the rules and procedures. Corporate governance sets objectives in line with the social, regulatory and market environment while including mechanisms for monitoring actions, policies and decisions of principles and their agents. Indeed, practices of governance are to align to the interests of stakeholders. Therefore it is managers' duty to maximize shareholder value (Friedman 2007). In order for a firm to have better oversight over the work executive managers there has to be inclusion of outside directors.

Some of the suggestions for a possible corporate governance reform towards better oversight are related to proliferating of the influence of outside directors. Consequently, there can be increase the number of outside directors (more extreme proposals include majority of outside directors), the process of nomination and directorial compensation can be removed from inside directors, retirement ages of inside directors should be made mandatory, requirements for shareholder involvement of directors into the firm as they should own shares, etc. (Jensen 2010).

d) The Alignment of Direct Managerial Financial Incentives

Direct financial incentives (instruments, warrants, shares, etc.) can be a good way to inline managerial behavior and personal goals to those of principles therefore maximizing share value. This is because it share value is seen as viable mechanism for reducing agency costs, targeting directly the problem of moral hazard, however this mechanism does not affect adverse selection.

Incentives in financial instruments also could be introduced in combination with corporate governance mechanisms of control to create stronger incentives for managers, increase performance and value. There can be a corporate governance structure with majority of outside board members as control and significant compensation incentives in financial instruments for well performing managers. It must be noted that incentives in financial instruments that relay strongly on higher share price could induce inefficient risk taking behavior of managers that by any cost try to push the price of shares higher while risking the structure and well-being of the firm (Jensen and Murphy 1990).

e) Shareholder Empowerment

Another mechanism for reducing agency costs could be shareholder empowerment, that is, increase of powers of shareholders over those of the management. This mechanism is envisioned as a possibility go give shareholders managerial powers. Anyhow, it is shareholder empowerment is also criticized on the bases that it will compromise centralized management and thus reduce efficiency of overall management (Bratton and Wachter 2010).

The mechanism of shareholder empowerment gives more power of public shareholders to govern the firm while reducing costs of involvement, and it is usually best introduced in firms and markets where institutional investors are dominant. Institutional monitoring can cause raise of costs, representing only some of the shareholders, insider trading, political influences, etc. (Gilson and Kraakman 1991; La Porta, Lopez-de-Silanes et al. 2000).

3. THE CASE OF MACEDONIA

The base of the transformation process from command to market economy of transition economies is a liberalization paradigm i.e. privatization, liberalization and stabilization, and it is well founded on the presumption that the ownership transformation is not just a necessary condition for a market economy, however a merely sufficient one. Hence, the system that was introduced was largely dependent on different policies of ownership and control hasting the transformation. Characteristics that are typical for such process: first, undeveloped institutional constraints on discretionary managerial behavior such as property-rights, governance structures and market institutions; second, economic agents are quasi-state officials/owners/managers with lack of international existence; third, aggressive rent-seeking culture; fourth, the winners on the market are these perusing asset-stripping and export of capital; and fifth, the

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objectives of new owners of privatized enterprises are not profit maximization, but rather unfair competition (Kornai 2000).

There is comprehensive literature analyzing ownership and control structures, where empirical studies confirm the difference in performance between state and privatized firms (Conyon, Girma et al. 2002; Apostolov 2011; Apostolov 2013), as well as, that newly formed private firms are more efficient than both state and privatized firms (McGuckin and Nguyen 1995; Apostolov 2013). In this study we use integral theoretical approach which is based on property rights and share of ownership to study the relation to control structures. This research does not use profit maximization as core hypothesis, but rather it is inclined towards the utility-maximization hypothesis (Conyon, Girma et al. 2002). This hypothesis was accepted as main behavioral hypothesis which narrowly explains individual choices made by managers, workers and owners.

Ownership and Control Structures in Macedonia

The economy of this country is characterized by three major groups of firms classified by type of ownership: 1) corporatized state-owned, 2) private firms established de novo, and 3) foreign-owned firms.

Property-Rights Structures

1. Property-Rights Structures in Corporatized State-Owned

Different kinds of business organizations can be examined through the property-rights approach. This research uses this approach as foundation for the examination of the ownership structure of corporatized state-owned and private firms established de novo.

The state sector is characterized by corporatized enterprises. Corporatized state-owned firms have property-rights structure which is linked to state ownership of assets. In such case the government appoints a board of directors as management of the firm and owns the right of residual risk. The key agents of property rights is the owner i.e. the government and the managers appointed through board of directors. The risk bearing is appropriated by the state; whereas, the function of management is assumed by managers. According to the property-rights theory (Driffield and Munday 1998), the government must bear the residual consequences from the shocks. Hence, the managers have less motivation to manage it properly, and in practice the 'asset – tunneling'[1] phenomena (Mata and Portugal 2004) is common.

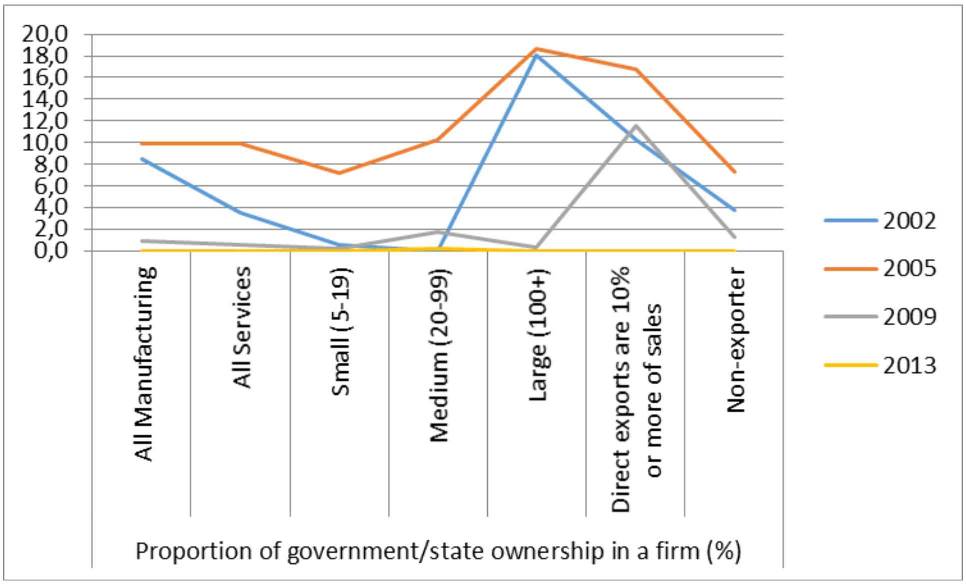

FIGURE 1 - MACEDONIA- PROPORTION OF STATE OWNERSHIP
Source: World Bank Microdata Library - Enterprise Surveys 2015

2. Property-Rights Structures in Newly Formed Private Firms

Newly formed private firms have distinct characteristics of their ownership structure which can be classified in two main groups. First, most of them are sole proprietorships where the owner is also a manager, and that constantly invokes the principal–agent problem in the control segment (who controls whom?).

Second, few newly formed firms function as a proper company i.e. their ownership structure has the fallowing shortcomings: 1) one party-private firm that concentrates all assets under its control; 2) all the shareholders own the right of residual risk; 3) the controlling shareholder appoints the other members of the board of directors as managers; 4) the shareholders, especially if also employees, are pressured to sell the shares to the board through public offering. The personal welfare of the largest shareholders is directly related to the ownership structure which makes management decision very personal and inclined to the mistakes of owner/manager.

[1] 'the transfer of assets and profits out of firms for the benefit of those who control them'

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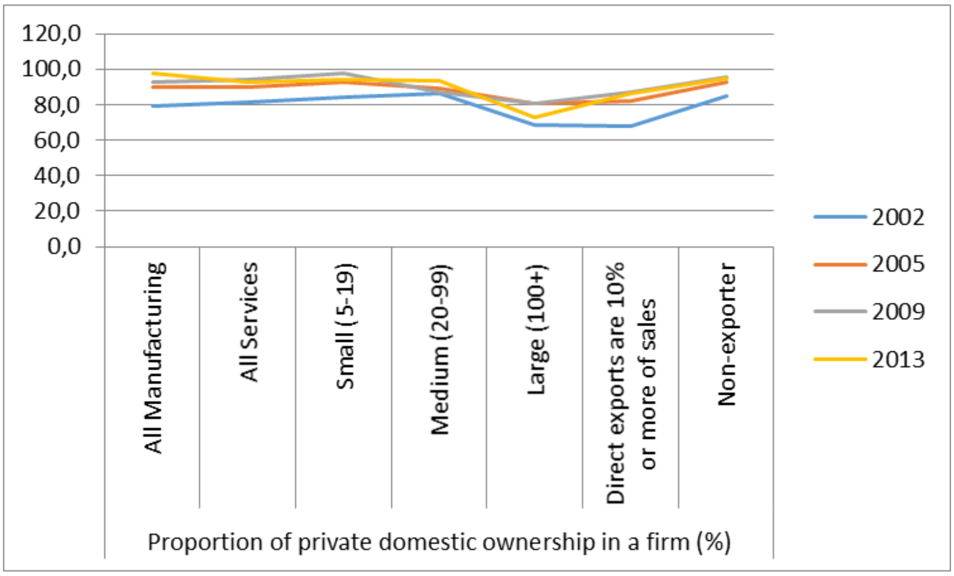

FIGURE 2 - MACEDONIA- PROPORTION OF PRIVATE DOMESTIC OWNERSHIP
Source: World Bank Microdata Library - Enterprise Surveys 2015

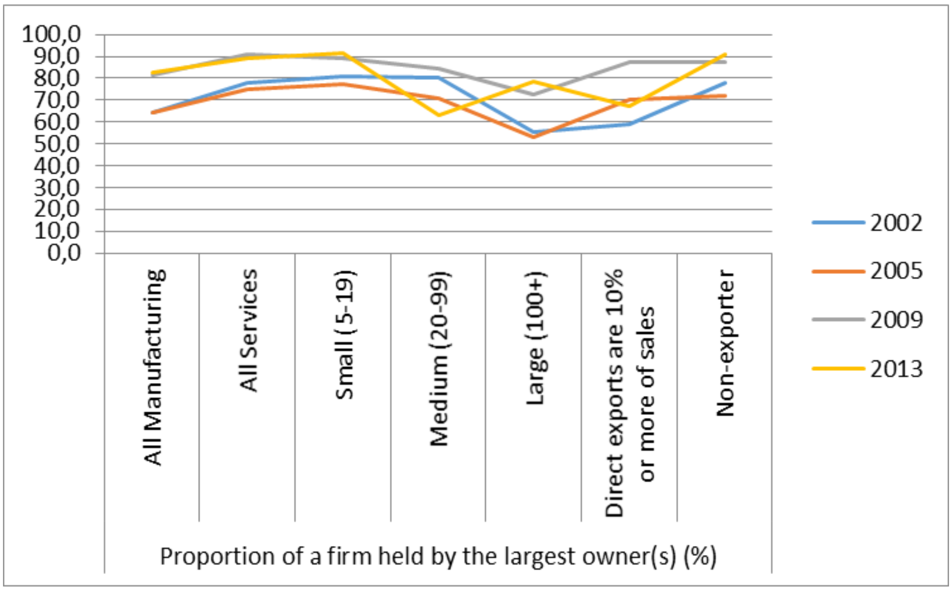

FIGURE 3 - MACEDONIA- PROPORTION OF FIRM HELD BY THE LARGEST OWNER
Source: World Bank Microdata Library - Enterprise Surveys 2015

3. Property-Rights Structures in Foreign-Owned Firms

The basic way for a firm to enter a market through foreign direct investment would be to set up a directly-owned subsidiary. There are other international companies that do not use such flat ownership structures, and enter into the market with more complex forms of ownership structure (Gomes-Casseres 1989; La Porta, Lopez-De-Silanes et al. 1999). Foreign direct investments have increased fraction in Macedonian economy, and understanding how they are organized is important for two reasons. First, the ability to create complex ownership structures that reach across borders can affect firms' real choices, such as, asset location, employment, or production. Second, firms design the internal structures to circumvent legal constraints imposed by their host countries, and unfortunately it is the case also in the analyzed country (Kesternich and Schnitzer 2010). Mainly there are two important ownership structures developed in the Macedonian economy with dominance of foreign ownership: 1) buy-outs of previously well-to-do state owned companies where the foreign owner has the controlling or whole ownership and 2) Greenfield and Brownfield investments due to imposed government measures (mostly in Technological Industrial Development Zones (TIDZs)) where ownership is complete, but they are exempt from domestic tax and customs system.

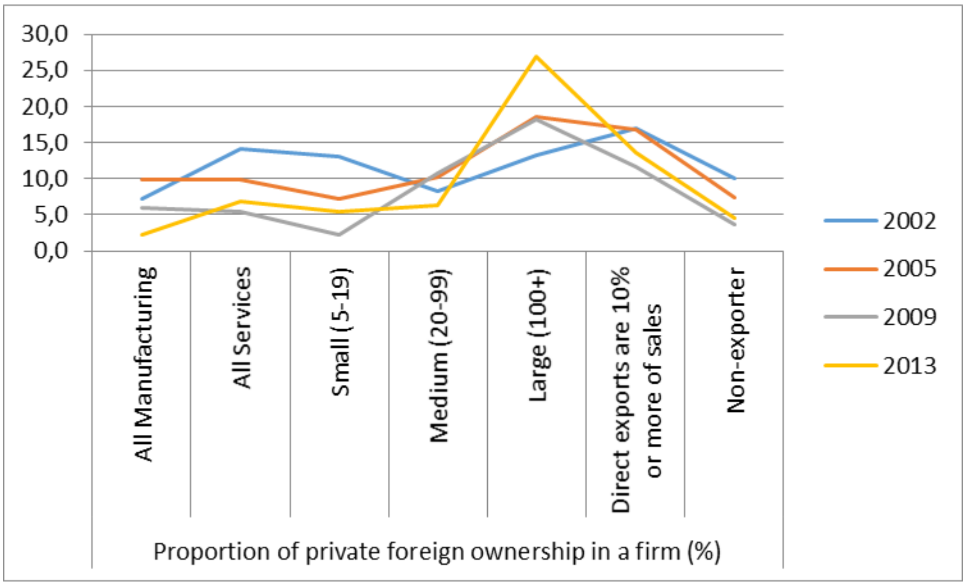

FIGURE 4 - MACEDONIA- PROPORTION OF PRIVATE FOREIGN OWNERSHIP IN A FIRM
Source: World Bank Microdata Library - Enterprise Surveys 2015

Enterprise Behavior

1. Enterprise Behavior in Corporatized State-Owned

There are specificities related to the ownership structure and behavior of corporatized state-owned companies. Further, most important probably is the fact that they have conditioned property-rights structure, that is, the only nominal owner is the government. There is Board of Directors, but most often than not, managers have dominant sway in decision-making. In general terms there is separation of ownership and control, nonetheless weak state control through boards of directors is major reason for great managerial freedom of choice and accumulation of capital at the expense of the company (Aivazian, Ge et al. 2005). Such position of the Board of Directors is due its composition, to be exact; it

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consists of representatives nominated by the sole owner (the government), who have interests that are not in line with those of the company or in most cases definitely different (Erakovic and Wilson 2005). This is why corporatized state-owned enterprises exercise passive market strategies and only make profit if they are natural monopoly (even this could be questioned), hence passive managerial strategies of restructuring are common and tied to 'asset tunneling' (Shirley 1999). Performance indicators are low and will remain such due to disinvestment in their capital and equipment base.

2. Enterprise Behavior in Newly Formed Private Firms

Newly formed private firms have concentrated ownership where the dominant owner has majority 50% to 80% or it is sole owner with up to 100% of the company. The basic characteristic of such ownership structure is that the dominant owner is de-facto manager of the enterprise (Li, Vertinsky et al. 2004). This is in strict collision with separation of ownership and control and the essential source of defective management of the firm, where it is not expected efficient managerial behavior but rather a firm driven by personal incentives and idiosyncrasies. These companies also have passive managerial strategies of restructuring and defensive position regarding cooperation with outside/foreign companies in order to protect capital (usually tied to the personal wealth of the owner) (Estrin, Hanousek et al. 2009). Nevertheless, newly formed private firms have better performance indicators (profitability, productivity, and age of capital) compared to all the other firms. The hope is that they will adopt to market conditions as the time passes by and restructure their corporate governance functions (Li and Xia 2008).

3. Enterprise Behavior in Foreign-Owned Firms

Present literature on productivity spillovers can be separated into two general categories: inter-industry, subject to research is inter-industry dynamics i.e. horizontal spillovers; and intra-industry, mainly focused on vertical spillovers.

The literature gives negative, horizontal outcomes usually conditioned on several intra-industry factors in different parts of the world (Blomström and Sjöholm 1999; Konings 2001; Gorodnichenko 2007).

Nevertheless, there are positive, vertical outcomes noticed in many studies which deal more specifically and consider factors in depth, such as region of origin and export orientation (Monastiriotis and Alegria 2011), distinctiveness of beneficiary economy and related FDIs (Acemoglu, Griffith et al. 2010), firm and sector characteristics (Halpern and Muraközy 2007; Keller and Yeaple 2009).

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4. DISCUSSIONS

Possible paths

Due to the analysis we can establish relation between ownership and control structures. Indeed, there are positive and negative pressures of introduced policies on ownership in this case study, however it is evident that overall, there is satisfactory picture of governance and enterprise restructuring progress.

The changes in ownership shapes control structures within specific characteristics of national governance systems to overall economic movements, with enormous influence of especially foreign direct investments and influx of foreign ownership. Thus, it is apparent that the new way of functioning of the systems creates an endogenous competitive characteristics for the home companies due time, through the process of learning and cooperation with foreign companies or their capital.

However, there is still more to be done in order to bring these economies closer to the standards of developed ones. Indeed, it is needed considerable improvement of corporate governance, institution-building to control agency problems and imposing already adopted regulation, as well as, enforcing new enterprise restructuring policies, within existing policies of overall transition economy restructuring.

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