WHAT DETERMINES THE PERFORMANCE OF FIRMS, OWNERSHIP OR MANAGEMENT STRUCTURE?

MR. GODFREY B. MOLEFE
Lecturer at the University of Botswana

ABSTRACT

"Ownership is less important than market structure in determining the performance (success) of firms" is the argument of this paper. It starts by defining the relevant terms. Secondly, it briefly distinguishes monopoly and perfect competition, being pertinent terms concomitant with market structure. It then proceeds to compare efficiency of a firm in a monopolist industry with that of a firm in a perfectly competitive industry, both operating under the same cost and demand conditions. The significance of ownership to efficiency is then explored, followed by a discussion of managerial control mechanisms under either type of ownership. This is followed by a conclusion.

Ownership of a firm can be either private, mixed or public. A privately owned firm is one whose share capital is held wholly by registered shareholders. They appoint a board of directors who are responsible for the running of the affairs of the firm Shareholders are principals and directors agents, hence the principal-agent relationship. On the other hand, a public enterprise is state-owned, with every citizen member of the public as an owner. A public enterprise, too, is run by a board of directors. But they are appointed by parliament through a concerned cabinet minister who accounts for the enterprise to the public through parliament. A mixed enterprise is the residual; falling somewhere between the private and public enterprise.

Market structure describes how buyers and sellers interact. Market structure is determined by the demand and cost conditions prevailing in the market. The extreme market structures are monopoly on the one hand and, on the other, perfect competition. A perfectly competitive industry is characterised by many firms whose individual output decisions are trivial relative to the market price and the firms are therefore price-takers. Conversely, a monopolist industry is constituted by a few firms, or a single firm in the case of natural monopoly, which are price-setters. Compared to a price-take in a perfectly competitive industry operating under the same demand and cost conditions, a firm in a monopolist industry can raise the price of a commodity by restricting the output. Figure 1 below shows cost and revenue curves of a monopolist industry firm versus a competitive industry firm:

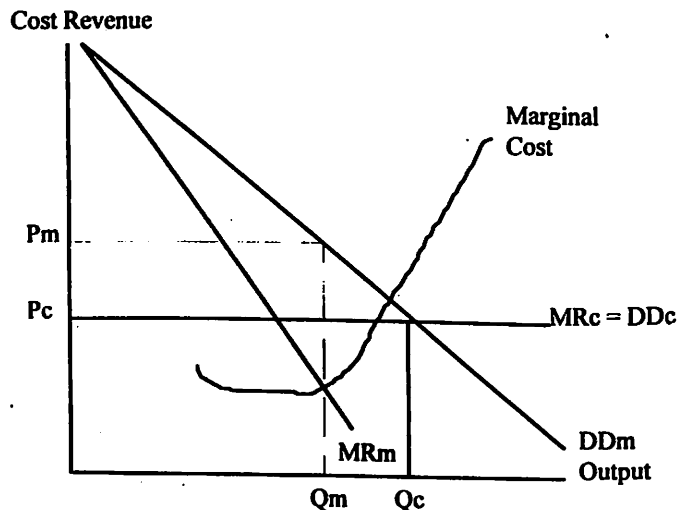

FIGURE 1

Key to Figure 1:
Pm = price under monopoly
Pc = price under competition
MRm = marginal revenue, monopoly
MRc = marginal revenue, competition
DDm = demand, monopoly
DDc = demand, competition
Qm = output, monopoly
Qc = output, competition

A monopolist firm is one of a few suppliers of a commodity that has no close substitutes. If the monopolist is a single firm, it is therefore also the industry for that particular commodity. A monopolist firm has a downward sloping demand curve (DDm), meaning that as output falls the price rises. At any level of output a monopolist's price exceeds marginal revenue (DDm>MRm). For any firm, monopolist or perfectly competitive, to achieve profit-maximisation marginal revenue must be equated to marginal cost. By being a price-setter, a monopolist achieves this profit-maximisation condition at a restricted output level (Qm). That being the case, for consumer welfare to be maximised the optimal output is determined (in Figure 1) by the intersection of the marginal cost and demand curves because at that level of output marginal benefit and marginal cost of output are equal. But under monopolist conditions the price is set above the marginal cost, that being the most viable position for a firm to remain in business. And, at that price level, buyers are willing to pay more for output than it cost to produce. Therefore, output can be restricted as desired.

In a competitive industry the demand and marginal revenue curves coincide and are horizontal (MRc=DDc). In this industry a single firm is a price-take and equates the marginal revenue of output to its marginal cost where marginal cost and demand curves intersect. Thus, a firm in a competitive industry maximises profit at the socially optimal level of output. The firm also maximises profit at a lower price compared to a monopolist under the same cost and demand conditions. For these reasons, competition sanctions efficiency and the lack of it causes inefficiency.

Efficiency is about cost minimisation. A firm facing intense competition has to minimise its cost in order to remain in business because it cannot tamper with the market price. Where there are many suppliers whose individual output decisions are trivial to the market price, the only way each can perform favourably is to cut costs and increase its own contribution margin. But, a monopolist firm being one of a few suppliers, or the sole supplier in some cases, has no pressure to cut costs. The firm can always restrict output and that will raise the market price. Market structure is therefore, in the main, responsible for efficiency. And this efficiency can be revealed without a necessary reference to the type of ownership of the firm.

But ownership may be significant; for it is observed that "economic efficiency requires both that individual firms attain the lowest possible cost curve and that the correct balance of output is attained across firms and industries. One aspect of the debate about whether public or private firms are more efficient rests on the incentives for managers to keep costs down. In the private sector, compensation is likely to be the most effective management discipline. In the public sector, it all depends on how effectively the government monitors managers in nationalised industries" (Begg, et al, 1984: 324). This states the theoretical contention that private managers are encouraged to be efficient by compensation, which could be stock options, profit-related bonuses or similar rewards. But a reward with no accompanying penalty is a weak device and is limited in encouraging efficiency. At any rate, private managers are already remunerated by salaries and having to spend further on them to make them do what they are already paid to do can be construed as a form of inefficiency, one which is transparent even to the man in the street. What should really matter is the market place, where a firm's advances are rewarded and regressions penalised by an automatic and dependable mechanism of competition. Private managers will not necessarily be efficient unless subjected to stiff competition; for even with these incentives managers of monopolist firms can perpetrate inefficiencies. It is observed accordingly that "where the market is unsparing in its rewards

for accomplishments and its penalties for poor performance, one can be quite sure that firms' inefficiency will not be readily tolerated" (Blinder and Baumol, 1979: 513)

It is claimed that because privatised firms are accountable to shareholders this accountability increases pressure on these firms to reduce costs and operate efficiently (Hardwick, et al, 1982). This seems to overstate the amount of control shareholders wield on managers to act consistently with enterprise objectives. In both private and public enterprises the agency problem exists; there is no simple and yet dependable mechanism that principals can use to make agents act in the manner principals want. "Property rights theory of the firm suggests that public enterprises should perform less efficiently and less profitably than private enterprises" (Board man and Vining, 1989: 1). The theory suggests that because public ownership in non-transferable, specialisation in one enterprise is impossible. This leads to weak incentives to monitor managerial discretion. But it appears that even in private enterprises incentives to monitor discretion and performance are weak because of the 'free-rider' problem. An individual shareholder assumes that other shareholders will monitor performance on his and their own behalf, and eventually no-one does it. It therefore makes no difference what ownership (public or private) an enterprise is under.

Empirically, public enterprises have been found to perform substantially worse than similar private firms and these differences existing in competitive environments (Board man and Vining, 1989). This, then contradicts the 'ownership-insignificance' argument in the performance of firms. The following purports to reconcile the seeming contradiction. Public enterprises, in the main, are established as governments' instruments for pursuing activities not privately profitable, some of which require subsidy, for example; providing passenger rail service to remote areas regardless of demand; cutting prises to curb inflation; increasing prices to raise revenue for government; employing manpower excessively to ameliorate unemployment; or sacking workers to cut government expenditure. In this context, privatisation excels over nationalisation in so far as it makes it more difficult for governments to use enterprises to achieve political objectives, and no more. A counter-argument might be that private firms can also be manipulated through the fiscal system, for example, by being subjected to confiscatory taxes.

Another test for the influence of ownership on performance, not unrelated to the foregoing, is whether equally good performance can be achieved with either form of ownership. The answer is 'no, public firms tend to be poor performers.' One reason appears to be the multiplicity of objectives on public enterprises which encourages managers to perform satisfyingly on all objectives but unsatisfactorily on each specific one; being 'jacks of all trades but a masters of none'. Another is that public managers usually face no market mechanism but government competition policy, which, unlike Adam Smith's invisible hand of the market, cannot proceed unfettered by government's political biases. Yet another reason is that governments tend to nationalise monopolist enterprises claiming market failure, bailing them from inefficiency to tax-payer financed subsidy with ineffective monitoring. However bad, nationalising and directly (mis) managing might still be a better choice than keeping private and attempting to subsidise. The former makes more economic and political sense than the latter. And, of course, it defies the proposition 'leave natural monopolies in the private sector, but regulate their activities' by Begg, et al, (1984), which disregards the 'regulatory capture' and 'information asymmetry' problems that impede regulation.

The control of managers to get desired performance must be automatic and dependable. In a monopolist industry the market structure fails to provide such a mechanism. In order to control the performance of managers, owners must have independent cost information relating to the firm's activities. This information can then be used to set the targets for the managers. Usually managers furnish this very information used to set their targets. And, because of information asymmetry between managers and owners,

managerial performance and discretion are difficult to control. In a monopolist environment this problem is especially acute because firm cost data may also be industry cost data, with no independent industry averages. That way, inefficiencies may proceed unchecked by owners and worse still, by the market. In a competitive environment there are many competing firms, and reliable industry averages exist enabling owners to set managers' targets objectively and reliably. Although owners might still use managers' figures to set managers' targets, the existence of detrimental information asymmetry is limited; managers simply know that they cannot over-use their leverage (and if they do, not for long) In addition to this, competition itself exists and provides an augmenting check on owners' fight in overcoming the problem.

In conclusion, therefore, we cannot agree more with the proposition that "the key issue is not ownership itself but rather the severity of market competition, or its substitute government competition policy, which the industry faces" (Begg, et al, 1984: 321) that determines the performance (success) of firms; the contribution of ownership is significant, but does not make ownership the over-riding factor.

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