1. Introduction: the modern firm, corporate governance and investment

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The book is organized into four parts. Part I contains overviews of the theory of the firm. Part II is devoted to firms and organization of economic activities. Part III deals with how the institutional framework of an economy affects investments made by firms. Part IV looks at the impact of ownership structure and board composition on firm performance.

I. OVERVIEWS

Part I contains two overviews of the theory of the firm from different perspectives. ‘Opening the black box of firm and market organization: anti-trust’ by Oliver E. Williamson presents an overview of the characteristics of the transaction cost approach to the study of economic organization. The antitrust implications of this new view of economic organization are also considered. Thus, this chapter reviews both the positive and normative aspects of Williamson’s theory of the firm, and offers a contractual view of economic organization. The black box of the firm is opened in the sense that the governance attributes that distinguish the firm from the market are outlined. The market of the ‘pure vanilla’ type (spot contract character) found in most textbooks is complemented by the contractual deviations that can be characterized as hybrids of market and firm. The new explanations of antitrust phenomena provided by transaction cost analysis are discussed. Instead of solely focusing on market power aspects of vertical market relations, pricing practices and horizontal and conglomerate mergers, a transaction cost analysis provides a broader picture by also including cost-reducing explanations. Williamson shows how these alternative explanations gradually have been recognized by US antitrust authorities.

‘The corporation: an economic enigma’ by Dennis C. Mueller looks

at how the view on the corporate form of business has changed amongst economists since Adam Smith. The chapter addresses the key issue in corporate governance about efficiency implications of ownership and control in corporations. An overview is provided on how economists' views of the corporation and its performance had changed over time. The early economists such as Adam Smith, John Stuart Mill and Alfred Marshall offered descriptions of corporate behaviour based on their observations of how companies function. Berle and Mean's book *The Modern Corporation and Private Property* from 1932 is also based on observations that are supported by an impressive amount of descriptive data. The neoclassical view emerging during the 1930s and 1940s represents a different way of doing research on the firm and corporate form. For pedagogical and simplifying reasons the firm is looked upon as a profit maximizing entity. The managerial challenge of this neoclassical view and the ongoing debate between these two schools of thoughts are then discussed. One way to resolve the conflict between these two views is to look at the return on investments. Such studies have been done recently and show that investment efficiency has actually improved since the 1990s in some countries like the United States. Possible explanations are disciplining takeovers, increased product competition due to globalization and the growth of institutional shareholding.

II. ORGANIZATION OF ECONOMIC ACTIVITIES

In Part II, chapters studying the firm from an economic organization perspective are found. The first chapter, by Per-Olof Bjuggren and Johanna Palmberg, (entitled 'A contractual perspective on the firm with application to the maritime industry') introduces a contractual model of the firm and applies it to explain how the maritime sector is organized. The capacity of the firm as a legal person to enter into contracts with suppliers of goods and services, customers and creditors is highlighted. It is argued that mutual dependency is what determines the character of contractual relations. The employment contract and ownership of assets in adjacent vertical stages enables the firm to supplant price as coordination mechanism in the production of goods and services. The maritime industry offers a rich flora of contractual relations due to differing degrees of mutual dependence between shipper and carrier. Both the firm and the freight contract are analysed from a contractual perspective. A contractual explanation is also offered for the phenomenon of third-party management.

A second chapter, by Kirsten Foss, (entitled 'Authority in the knowledge economy') takes a closer look at authority relations between employer and

employees. In transaction cost economics, it is claimed that the possibility to use authority as a mode of coordination is what primarily characterizes firms. Authority is a key concept in the theory of the firm, and Foss throws light upon it. She claims that the emerging knowledge economy makes it necessary to take a closer look at the different dimensions of the authority concept in order to understand ongoing changes in economic organization. From a review of authority in the economic literature, the conditions under which it is efficient to use authority for coordination, contract enforcement, and dispute resolution are identified. Finally, how these conditions have to be adapted to an emerging knowledge economy is discussed.

The third chapter, by Gunnar and Åsa Eliasson, (entitled ‘Competence and learning in the experimentally organized economy’) offers a new evolutionary perspective on how firms emerge and disappear. The authors picture an economy with boundedly rational and myopic actors who try to take advantage of perceived business opportunities. Success is to a large extent dependent on the interaction of actors in so called competence blocs. In a successful competence bloc, customers, innovators, entrepreneurs, financiers, exit markets and industrialists interact efficiently in the sense of minimizing the cost of keeping losers on for too long and losing the winners. The customer has a key function in a bloc by being the ultimate arbiter of value. In the experimentally organized economy that Gunnar and Åsa Eliasson envision, economic organization and ‘the firm’ are a result of how the competence bloc is structured. Efficient ways to organize the relations between the actors in a bloc will be rewarded by increasing returns, which make the organization viable.

III. IMPORTANCE OF THE INSTITUTIONAL ENVIRONMENT

Part III consists of chapters dealing with investment and legal environment. Johan Eklund’s contribution (entitled ‘Corporate governance and investment in Scandinavia – ownership concentration and dual-class equity structure’) looks at how ownership structure affects investment performance in the different Scandinavian countries. As a measure of investment performance, the marginal q developed by Dennis Mueller and Elisabeth Reardon is used. From legal and political perspectives the Scandinavian countries are rather similar. But there are still distinctive differences in separation of ownership and control through the use of dual-class shares. Sweden has the highest fraction of listed firms that use dual-class shares, while Norway has the lowest fraction. The implications of these differences on investment performance are investigated. It turns out that in Norway

the marginal q estimate indicates overall efficient investment performance among the listed firms, while the estimate for Swedish and Danish firms indicates over-investment – marginal returns on investment are lower than costs of capital. A non-linear effect of ownership concentration in Scandinavian firms is also found, implying a positive but marginally decreasing effect of ownership concentration on investment returns.

In a second chapter ('The cost of legal uncertainty: the impact of insecure property rights on cost of capital') Per-Olof Bjuggren and Johan Eklund study how institutional risk influences the required return on international investments. Institutional risk due to weak property rights and investor right protection represents a non-diversifiable risk to international investors, as these rights are fairly stable over time. Hence investors are likely to demand a risk premium in those countries where these rights are weak. The required return on investment in such countries will accordingly be higher. The capital asset pricing model (CAPM) is used to test for the importance of taking institutional risk into consideration, and to find out the risk premium associated with institutional risk. It turns out that the explanatory power of the CAPM is considerably increased if such a risk is taken into account. Furthermore, the risk premium due to institutional risk is found to be significantly higher for developing than for developed countries.

A third chapter, by Simon Deakin and Ajit Singh, ('The stock market, the market for corporate control and the theory of the firm: legal and economic perspectives and implications for public policy') takes up the question of how important an active market for corporate control is for economic efficiency. The authors have severe doubts about whether hostile takeovers have positive effects on efficiency and growth in developed countries. Their discussion of the pros and cons of a market for corporate control starts with the observation that shareholders do not 'own a company' in the sense of being entitled to 'a particular segment or portion of the company's assets, at least while it is a going concern'. Furthermore, directors' fiduciary interests of loyalty and care are owed to the company. Even though in practice it is foremost the interests of the shareholders that are catered to, other stakeholders' interests are to a differing degree also recognized. This is especially the case in civil law systems. It is argued that it cannot be taken for granted that company law and articles of association that serve as obstacles to takeovers are at the expense of economic efficiency.

Two strands of thought in the economic literature are referred to in Deakin and Singh's economic analysis; On one hand, there is the principal-agent view of the market for corporate control that is used in financial economics. On the other hand, there is a more antitrust oriented analysis used

in industrial organization. The views of these schools differ. While financial economists have focused on takeovers and mergers as a mechanism to discipline managers, industrial economists also stress their negative effects on the overall economy. Balancing different views of efficiency implications, Deakin and Singh come to the conclusion that hostile takeovers are likely to harm the prospects for growth in developing and transition economies.

IV. OWNERSHIP STRUCTURE, BOARD COMPOSITION AND FIRM PERFORMANCE

Part IV contains chapters that examine how the composition of the board, management relations and ownership structure affect firm performance. A first chapter by Daniel Wiberg ('Institutional ownership and dividends') studies the relationship between institutional ownership and dividends. Wiberg wants to see both whether there is a positive relation between institutional ownership and dividends, and whether there are more rational reasons than 'short-termism' for explaining such a relation. Swedish data are used to test the hypotheses. The Swedish institutional framework is interesting as there is widespread use of dual-class shares and the tax rules make dividends more attractive to institutional than to other ownership categories. Through the use of dual-class shares, ownership can be separated from control, leading to pronounced agency problems. One way to overcome these agency problems is to insist on dividends. If such a relationship exists it implies that dividends are higher in firms with greater separation between ownership and control due to dual-class shares. Wiberg finds this to be the case, and that institutional ownership has a positive impact on dividend growth.

Camille Madelon and Steen Thomsen ('Contracting around ownership: shareholder agreements in France') use data from large, French listed firms to examine the effects and determinants of shareholder agreements. These agreements represent a way to contract around the official ownership structure. While the relationship between observable formal ownership and behaviour/performance has been extensively studied, there has been no study of the relationship between real ownership structure (considering contracts between shareholders as well) and behaviour/performance. Madelon and Thomsen's study is one of the first steps towards 'filling this void'. It is an explorative study that analyses agreements from a transaction cost approach view. The costs and benefits of acquiring control through contracting amongst shareholders are compared with the alternative of outright ownership. Several theoretical propositions are derived that consider ownership and industry characteristics and network ties as

explanations as to why contractual agreements are chosen. Propositions about the impact of shareholders' agreements on economic performance are also derived.

'Board governance of family firms and business groups with a unique regional dataset', by Lluís Bru and Rafel Crespi, is both a methodological paper about how to empirically study family business and a description of what family businesses look like in the Balearic region of Spain. They have managed to trace family ownership and management by use of the Spanish 'two-surnames' system. This system has two features. Married women usually do not change their name and newborns have both the father's and the mother's surname. This surname system has made it possible to trace both ownership and involvement in boards and management by family members. Besides family companies, it has been possible to trace business groups under the control of associated families. The importance of family firms and groups in the Balearic economy and the characteristics of the diversification patterns of family business groups are described.

Reidar Øystein Strøm ('Better firm performance with employees on the board?') uses data from Norwegian listed firms to analyse how co-determination affects performance. He distinguishes between direct and indirect effects of employee directors. In the theoretical literature both positive and negative effects of employee directors on performance are envisioned. Employee directors might contribute to positive performance by bringing more information about how the firm functions and enhancing the incentives to invest in firm-specific human capital. On the other side, owners' and employees' interests might not be aligned, producing a negative effect on performance. Most empirical studies find a negative impact on performance. Strøm takes the analysis one step further by taking account of the reactions of the shareholders to anticipated negative effects of employee directors. By adjusting the composition of the board and the financial leverage of the firm, these negative effects can be counteracted. This indirect effect is taken into consideration in a simultaneous equations framework. A three-stage least squares methodology with fixed effect is used to estimate both the direct and indirect effects. Even though indirect endogenous effects are taken into account, the results of the empirical analysis show a negative impact of employees on the board.

Wolfgang Drobetz, Klaus Gugler and Simone Hirschvogl ('The determinants of German corporate governance ratings') analyse corporate governance rating in Germany. As in many other European countries, Germany has since 2002 had a Corporate Governance Code of a 'comply or explain' kind. Instead of assessing the impact of code fulfilment on performance of firms, Drobetz, Gugler and Hirschvogl choose to analyse the determinants of corporate governance rating. One advantage with this approach is that

an endogeneity problem due to self-selection is avoided. The analysis is to a large extent based on the assumption that there is a positive relation between firm performance and a high corporate governance rating. The determinants of performance studied are ownership concentration, the size of the supervisory board, choice of strict accounting rules, and the use of an option-based remuneration plan. Ownership concentration is hypothesized to be non-linearly related to ratings. The rationale is that it is only at high levels of ownership concentration that the entrenchment effect of ownership is balanced by the rewards associated with better performance. For the other determinants, a negative effect is found for board size, stricter accounting rules are positively related to performance, and stock-option schemes have a positive relation to rating. All the hypotheses are corroborated in the empirical analysis based on survey data from 91 German firms.

Mogens Dilling-Hansen, Erik Strøjer Madsen and Valdemar Smith ('Top management, education and networking') use Danish data to study how management can benefit from networking. Networking takes place through board participation by top management. They look at network ties between firms linked by ownership and between independent firms. The former ties are labelled internal ties while the latter are called external ties. Networking through external ties can increase the top management's knowledge of the competitive and technological environment of the firm. It can also facilitate collusion. Networking can then be expected to improve performance. Networking of an internal character can improve the control of subsidiaries. The extent to which networking will have a positive influence on performance can be expected to be dependent on education. An empirical analysis of a large sample of Danish firms finds a significant positive effect of internal network activities on firm performance, and that education implies a positive attitude towards networking. No other significant relationships can be traced.