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A theory of socialistic internal capital markets ☆

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Abstract

We develop a model of a two-division firm in which the "strong" division has, on average, higher quality investment opportunities than the "weak" division. We show that, in the presence of agency and information problems, optimal effort incentives are less powerful and thus managerial effort is lower in the strong division. This leads the firm to bias its project selection policy against the strong division. The selection bias is more severe when there is a larger spread in the average quality of investment opportunities between the two divisions.
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1. Introduction

A vast majority of corporate investment is financed with internal funds.[1] Since investment decisions made using internal funds are not subject to the same scrutiny from the external capital markets as those funded with new equity or debt issues, it is important to examine how effectively internal capital markets allocate funds to their best use. Although this research question is difficult to tackle directly, the availability of data on investments by major business lines (segments) of U.S. public companies allows researchers to compare investment decisions in conglomerate firms against investment decisions in focused firms. The related empirical literature typically shows that investment in one division of a conglomerate firm is sensitive to the cash flows of unrelated divisions and that conglomerate firms invest less in divisions from industries with good investment opportunities and more in divisions from industries with poor investment opportunities compared to their focused counterparts (see, e.g., Lamont, 1997; Scharfstein, 1998; Shin and Stulz, 1998; Rajan et al., 2000; Gertner et al., 2002).[2] Moreover, the empirical literature finds that this socialistic behavior is more severe when there is more diversity in the quality of investment opportunities across divisions in the firm (Rajan et al., 2000; Lamont and Polk, 2002; Billett and Mauer, 2003).[3]

These empirical observations are difficult to reconcile with agency models at the level of the CEO. For example, if the CEO has empire-building preferences, such models would predict overinvestment in all divisions instead of a reallocation of funds from strong to weak divisions. Accordingly, two recent models go a level deeper into a firm's hierarchy and focus on the role of rent-seeking activity by division managers. First, Scharfstein and Stein (2000) develop a model in which managers divert their time away from productive effort to enhance their outside options and increase their bargaining power when negotiating total compensation. The authors argue that such behavior is more problematic with respect to managers of weak divisions because the opportunity cost of being unproductive is relatively low for them. One way to mitigate this problem is to offer the manager a cash payment to refrain from such behavior. However, Scharfstein and Stein suggest that if there is another layer of agency between the CEO and shareholders, the CEO may prefer to distort investment in favor of the weak division rather than increase cash payments to the manager because the latter comes from discretionary funds (which the CEO can control and potentially divert to himself) rather than investment funds (which are assumed to be under the control of shareholders). One problem with this explanation is

[1]The use of internal funds as a percentage of total investment for nonfinancial corporations in the U.S. ranged from 72% to 108% annually between the years 1990 and 2000 (Brealey and Myers, 2003). The same percentage exceeds two-thirds in Germany, Japan, and the U.K. (Corbett and Jenkinson, 1997).

[2]The typical empirical strategy is to use the median Tobin's q of (traded) stand-alone firms in an industry to measure the quality of investment opportunities in a (non-traded) division of a conglomerate firm. Chevalier (2000), Whited (2001), Bernardo and Chowdhry (2002), Campa and Kedia (2002), and Gomes and Livdan (2004) argue against this empirical strategy because the decision to diversify (i.e., form a conglomerate) is endogenous and may be determined in part by the quality of the division's investment opportunities, and thus the median q of stand-alone firms may not be an accurate measure of the investment opportunities of a conglomerate division. A notable exception to the finding of socialistic cross-subsidization is that of Maksimovic and Phillips (2002) who use plant-level data from manufacturing firms and find that these firms reallocate resources in favor of strong plants when they experience a positive demand shock.

[3]Khanna and Tice (2001) show that firms with operations in multiple divisions of the same broad industry do not engage in inefficient cross-subsidization.

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