Ownership structure, governance, and innovation

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Abstract

This paper tests the impact of firms’ ownership structure on innovation in a context featuring pronounced ownership concentration and conflicts between large and minority shareholders. Using data for 20,000 Italian manufacturers, and accounting for the possible endogeneity of ownership levels, we find that ownership concentration negatively affects innovation, especially by reducing R&D effort. Conflicts between large and minority shareholders appear to be a determinant of this effect. Moreover, risk aversion induced by lack of diversification exacerbates large shareholders’ reluctance to innovate. Family owners support innovation more than financial institutions, but the benefits of financial institutions increase with their equity stakes.

1. Introduction

Technological innovation is a key determinant of firms’ performance (OECD, 2010). Innovation allows firms to enhance their productivity, break into domestic and foreign markets, and retain their leadership as market incumbents (Tellis et al., 2009). There is a growing consensus among scholars and policymakers that, in turn, firms’ ability to advance their technological frontier is influenced by their governance. Yet, there is little agreement on the way corporate governance exerts this influence. On the one hand, it is sometimes argued that firms with dispersed ownership (relatively common in the United States) have more incentives to engage in innovation because they diversify its risk across a large number of investors (see, e.g., Aghion et al., 2013, for a discussion). Furthermore, in recent years some policymakers have voiced the concern that firms with ownership concentrated in the hands of families (common in continental Europe and East Asia) may be reluctant to reallocate resources from their traditional business to risky new technologies (Onida, 2004). On the other hand, it is also claimed that firms with concentrated, stable ownership can better keep tight control of their activities, monitor their management, and take long-term views, which is essential for investing in new technologies that need time to yield results (The Economist, 2012).

These conflicting arguments are often based on anecdotes and case studies while the microeconomic evidence on the link between ownership and innovation remains scant. As we elaborate below, a broad body of studies document that ownership structure affects firms’ growth and profitability but do not ascertain the role of innovation in this link. The

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objective of this paper is to shed new light on the impact of ownership on innovation exploiting a rich, large scale survey of 20,000 Italian manufacturing firms conducted by the banking group Capitalia.

Italy constitutes an ideal testing ground for investigating the contrasting effects of ownership concentration, including possible distortions in firms' decisions due to large shareholders' entrenchment and expropriation of minority shareholders. The Italian business sector features a strong presence of medium-sized and small businesses, often characterized by informational opacity in financial markets. Italian firms also exhibit pronounced ownership concentration (Bianco, 2003; Bianchi and Bianco, 2008). These features allegedly expose firms to conflicts of interest between main owners and smaller shareholders, which could be detrimental to complex, long-term investments such as innovation. The structure of the Italian business sector is similar to that of several European and Asian countries for which scholars and policy makers voice concerns that excessively concentrated firm ownership may exacerbate conflicts between large and minority shareholders (Claessens et al., 2002). This setting contrasts instead with that of the United States, where the business sector consists predominantly of public companies with many dispersed shareholders and relatively low ownership concentration. In U.S. public companies, more concentrated ownership, especially of institutional owners, is often (though not necessarily) perceived to be a positive development for firms (Shleifer and Vishny, 1997).

Our sample comprises a large number of privately held firms as well as the universe of publicly listed Italian companies. The data set provides information on firms' innovation which is based directly on firms' responses to survey questions. This information includes details on the type (product or process) of innovations, as well as on the phases of the innovation process (invention and adoption of new technologies). The data set also contains thorough information on firms' ownership structure, such as the equity stakes and the types of the largest shareholders, the alignment between ownership and control, and the involvement of shareholders in firms' management. Another advantage of our data is the availability of instruments for firms' ownership structure. A challenge of any study on the relation between ownership and innovation is that unobservable factors can affect both. Moreover, reverse causality may be an issue as innovation can shape the ownership structure. Our strategy for tackling these issues is to employ information on past regulation of Italian local financial markets. Firms' access to external finance is a critical determinant of their needs and incentives to issue equity and open participation to new shareholders. We thus employ information on the regulation of local financial markets introduced in Italy in the late 1930s to capture exogenous restrictions on the availability of external finance and construct instruments for firms' ownership structure.

As we explain in the paper, two elements make our instruments suitable. First, the regulation introduced in Italy in the 1930s profoundly affected the structure of local financial markets for several decades, and indeed in the early 1990s this structure closely resembled that of the 1930s. Second, firms' ownership structure exhibits a high degree of persistence: such a persistence is observed in many countries (Bebchuk and Roe, 1999) and is particularly pronounced in the Italian context (Bianchi and Bianco, 2008; Istat, 2013). For these reasons, we expect that the regulation introduced in the 1930s affected firms' ownership structure during the decades in which it was in place and that this effect persisted for several years after the deregulation at the end of the eighties. On the other hand, the regulation is unlikely to have affected credit supply conditions for long after its removal. For example, consider a firm seeking credit in 2000. We do not expect that its probability of obtaining funds or its collateral requirement was significantly affected by a regulation removed more than ten years earlier. Therefore, our instruments are unlikely to pick any direct effect on innovation of local financial market conditions.

After accounting for its possible endogeneity, we find that ownership concentration negatively affects the probability that firms introduce product innovations. The effects are sizable: increasing the equity share of the main shareholder by one standard deviation reduces the likelihood of innovation by 15% (40% of the mean likelihood of innovation). Furthermore, ownership concentration is neutral for total investment, which signals that its effect on innovation does not merely reflect a broader effect on the total volume of investment. The estimates also reveal important non-linearities in the effect of ownership concentration on innovation: its negative effect does not manifest itself at low levels of the equity stake of the main shareholder, but kicks in especially at higher levels (e.g., above an equity share of 30%). We also obtain that ownership concentration especially depresses innovation in medium-sized and large firms and in firms operating in traditional industries. When we break down the innovation process into its phases, we uncover evidence that ownership concentration depresses R&D more than technology adoption.

The analysis then turns to study the mechanisms through which ownership concentration affects innovation. While in the United States managerial misbehavior allegedly constitutes the most prevalent form of corporate governance problems, in Italy, like in other European and Asian countries, firms are often exposed to conflicts between large and minority shareholders (Bianchi and Bianco, 2008). In fact, Italian firms feature a strong presence of individuals or families with sizable equity stakes who may extract private benefits or take decisions in their own self-interest that are detrimental to minority shareholders. Institutional owners are instead less common. Agency theory predicts that conflicts between large and minority shareholders are severe when ownership is separated from control because controlling shareholders do not fully internalize the effect of their decisions. The results do indeed reveal that firms in which the main shareholder does not

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1 In many Asian and continental European countries, the structure of the business sector is similar to that of Italy, with a significant importance of privately held small and medium-sized firms and widespread family ownership among privately held firms (see, e.g., OECD, 2014b,c, for a discussion).

2 Ownership concentration does not appear to have a significant effect on process innovations.
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