



'Corporate Governance, Incentives and the Internationalisation of Australian Business'

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ABSTRACT

Australia's increased trade ratios and greater outflows of foreign direct investment have been explained in the literature in terms of changes external to businesses. The firm is portrayed as a 'black box' in which management motivation and behavior does not matter. Using principal-agent theory and drawing on the insights of the internationalization process literature that learning to go abroad is both costly and time consuming, this paper argues that the extensive change in the structure and operation of the corporation governance system was a necessary but not sufficient condition in the internationalisation of Australian business after 1980.

INTRODUCTION

The environment in which Australian business operates has changed dramatically in the last 25 years. Competition in domestic product and factor markets increased following the reduction in trade barriers, new legislation directed against abuses of market power, deregulation of both financial and labor markets, and the 'privatization' of publicly owned business enterprises that were important providers of communications, transport, energy and financial services. These policy changes, known colloquially as 'micro-economic reform', had important implications for the allocation of resources in the economy. The price signals to which firms and consumers responded were increasingly market based rather than determined to some degree by administrative fiat. Industries that contracted in the first round of structural adjustment were those who had recently lost high levels of protection from trade barriers and other forms of subsidy. Those industries that had enjoyed collusive arrangements or government price fixing also experienced a shake out of the weaker firms. Thereafter, survivors and new entrants adapted to prices generated by demand and supply conditions in product and factor markets. One consequence of the longer-term adjustments was that Australian firms, particularly in manufacturing and services, became significantly more internationalized in their operations.

The contention of this paper is that the success or otherwise of the broad package of reforms was contingent on there having been a 'sea change' in the nature of corporate governance in Australian firms. Large Australian corporations were characterized by a separation of ownership and control in the post-World War II period. Agency theory, discussed below, predicts that managers and owners have different objective functions and that managers have the ability to pursue their goals at the expense of the owners. It could be argued that managers of large Australian companies had opted for a 'quiet life' in a heavily regulated environment for 30 years after 1945. They faced a radically different environment once the progress of economic reform began. Anticipating and reacting to changing market forces brought new challenges. Attempting to expand into overseas markets, a new experience for most Australian firms, meant even greater environmental turbulence and complexity. A significant shift in the pattern of corporate governance enabled a marked assertion of ownership rights. Owners came to possess a wider range of remedies through market instruments at a time when managerial performance was becoming more transparent.

This evolution in the system of corporate governance was not the consequence of premeditated or coherent policy. It was driven by many factors, some of which were unintended by-products of the process of economic reform, whose effects built cumulatively. One stream of reform was the rewriting of corporations and securities legislation in response to an upsurge in corporate malfeasance in the 1980s. These amendments materially improved the flow of information to the markets and defined duties and obligations of directors. The deregulation of the financial system in the early 1980s had powerful consequences for the development of a market for corporate control through providing funding for hostile takeovers and management buyouts. Changes in the composition of the balance sheets of both corporations and households in the 1980s and 1990s magnified the importance of corporate performance in determining both cost of funding and return to owners. In particular, the shift in social policy towards self-funded retirement and the introduction of compulsory superannuation had important consequences. Insurance firms and funds managers, as institutional investors, became increasingly important owners of equity. Further, the proportion of Australian adults owning equities also rose dramatically. The privatization of very large government owned business enterprises and the demutualization of large insurance and service corporations turned them towards profit seeking enterprises. In addition, their initial placement offerings (IPOs) added to the depth and liquidity of local equity markets.

These various changes combined to modify the system of corporate governance in ways that altered behaviors by managers, particularly in larger corporations with separation of ownership and control. Owners wanted profits and rising share values. By 2000 they were in a far stronger position to reward and punish managers than had been the case in the 1970s. Large corporations, many of whom already had dominant market share, faced constraints on expansion within the small and mature Australian market. Managers were increasingly prepared to explore and implement policies of internationalization to preserve or increase returns. Strategy reappraisal resulted in significant increases in internationalization at the aggregate level. The ratio of exports of goods and services to GDP rose from 15.2 per cent in 1975-79 to 19.0 per cent in 1992-96. This growth in outward trade was greatly exceeded by a rise in foreign direct investment, whose ratio of outward stock of FDI to GDP rose from 1.4 per cent in 1975-79 to 11.5 per cent in 1992-96.¹ These figures reveal the net outcome of increases in trade flows and investment that were partly offset by retreat and divestment as poorly performing international strategies were abandoned.

The paper will begin with a discussion of the changing nature of the system of corporate governance from the 1970s until the present. The following section will briefly review the policy changes that made the Australian economy more responsive to market forces, both at home and internationally. The final section will argue that the intersection of the new market-based economy and new system of corporate governance was a powerful enabling factor in the internationalization of businesses. The transformation of corporate governance was a necessary but not a sufficient condition for the newfound ability of Australian business to compete internationally.

Corporate Governance

This section provides a longitudinal study of the Australian system of corporate governance in the half century after World War II. It will be argued that it moved decisively in the 1980s and 1990s from a weak to a stronger form of the Anglo-American model. Further, it seeks to identify the reasons for this transition. It synthesizes a fragmented literature drawn from the fields of economics, sociology, law, finance and human relations. For the most part, the existing research findings relate to only a particular aspect of corporate governance, rather than discussing the system as a whole. Moreover, they are largely ahistorical and do not explicitly discuss the motivations for changes.

Corporate governance systems differ substantially between economies (Prowse, 1996). Of the three variants discussed in the literature, Australia falls clearly within the Anglo-American model that is characterized by the mediation of agency issues arising from the separation of ownership and control predominantly through market discipline rather than insider relationships (Stapledon, 1996, 11-14; Cheffins, 2001a; Cheffins, 2001b; Kaplan, 1997). The key characteristics of the system and a summary of the changes that have taken place are shown in Table 1. Of the six features identified by Kaplan, only the nature of involvement of the banks with their clients and the composition of boards of directors have remained unchanged over the past quarter of a century.

Table 1: Australian corporate governance, 1980-2000

	1980	2000
Banking System	No direct role	No direct role
Board of Directors	Primarily outsiders	Primarily outsiders
Ownership	Diffuse Non-corporate	Institutional investors
Takeover/Control Market	Minor	Major
Capital Markets	Relatively Illiquid	Liquid
Executive Compensation	Low	High

Adapted from Kaplan, 1997, 252.

It should be noted that Australian banks, unlike those in Germany and Japan, had never taken equity positions in firms to whom they were creditors. The relationships between banks and clients were at arms length with lending exposures being monitored through documents sent to the bank rather than discussed in the boardroom of the client. However, non-executive directors of banks often sat on the boards of other corporations (Rolfe, 1967; Alexander, 1998). These cross shareholdings represented only a minute fraction of the number of corporations to whom the banks lent. Moreover, a director of a bank did not directly represent the interests of their bank when sitting on another board. Executives of banks were not placed on the boards of client corporations.

Large Australian corporations are run by hierarchies of salaried managers who operate under the supervision of a board of directors representing the interests of the shareholders. The owners delegate the running of the business to the managers as the range and complexity of tasks expands and as their execution requires highly specialized knowledge. Agency theory predicts that managers will be more risk averse than owners when choosing investment options as the latter can spread risks across a diversified equity holding. Information asymmetries enable managers to choose actions and effort levels that are sub-optimal from the point of view of wealth maximizing owners. Agency problems result, not from a separation of ownership and control per se, but from the costs of writing, monitoring and enforcing contracts with employees (Hart, 1995; Fama and Jensen, 1983; Jensen and Meckling, 1976; Jensen, 1993; Milgrom and Roberts, 1992). A number of remedies are posited that would reduce the potential opportunistic behavior of managers. These include deterring under performance by facilitating resort to market disciplines such as takeovers and buyouts, and writing incentive contracts that tie remuneration of managers to performance (Jensen, 1989; Jensen, 1993; Thompson and Wright, 1995).

The shares of the largest Australian companies were listed on the stock exchange. An examination of the distribution of those share holdings allows us to gauge the extent of the separation of ownership and control, and the relative importance of differing categories of shareholder. Wheelwright (1957) concluded from the data on shareholdings in a sample of 85 of Australia's largest locally owned corporations as at 1953 that 'one-third of the companies ... are in the hands of management, over whom shareholders can have little control' (3). While at the other end of the spectrum, there were only six firms where a group of shareholders owned more than 30 per cent of the voting rights (4). This conclusion that shareholdings were diffuse rather than concentrated was broadly confirmed by a later studies of shareholdings of 299 manufacturing firms around 1962-64 (Wheelwright and Miskelly, 1967), and of 226 large corporations in 1974-75 (Lawriwsky, 1978). A summary of the extent of ownership by persons comprising the board of directors and family associates is shown in Table 2. The various studies indicate that instances of ownership by a group of individuals were rare. In the majority of cases no individual or group of persons held more than ten per cent of the total equity.

Table 2: Share of equity held by directors, 1952-1975

Directors/Group	Per cent	1952	1962-4	1974-5
Majority	>50	--	8.4%	7.6%
Minority	>10<50	#33.3%	25.8%	42.0%
Diffuse	0<10	66.6%	65.9%	50.3%
Sample size		72*	299	157

Note: # This figure refers to both minority and majority categories. * 'Industrials' only. Sources: Wheelwright, 1957, 120; Wheelwright & Miskelly 1967, Table 29, 40; Lawriwsky, 1978, Table 5, 19.

Monitoring agents is a difficult and costly exercise for owners. Part of the problem arises from information asymmetries. Managers know more than the owners about the business and the strategic choices available to it. Much of their actions are unobservable to outsiders and even to the non-

executive directors. Collecting and interpreting data about performance is both costly and difficult. Third party intervention by governments and stock exchanges mandating disclosure standards attenuates this problem only to a degree. Further, the remedies to unhappy shareholders are exit or the costly exercise of forming coalitions to propose and vote on motions at annual meetings. The more fragmented the shareholdings the greater the costs in organizing collective action, and the more secure the incumbent board and management. Owners of small parcels have strong incentives to 'free ride' on the monitoring costs borne by others.

Owners of large blocks of stock have a greater incentive to monitor the performance of managers and face lower costs of organizing to take action. The pattern of shareholdings amongst individuals, and between persons and institutions, has important implications for the workings of the system of corporate governance. Over the long term, the importance of institutional investors, particularly life offices and pension funds, has increased significantly. The trends are shown in Table 3. The data must be treated with caution when making comparisons as Wheelwright (1957) discusses ownership by type with respect to the total number of voting shares issued by companies in his sample, while the latter data (Davies & Peacock, 1997, 110) compared the market value of shares by type of holder. This caveat notwithstanding, the share of individual shareholders has fallen dramatically. In 1952 they held 76 per cent of issued shares and by 1995 shares owned by 'households' accounted for less than a quarter of the market value of shares traded on Australian stock exchanges. Households had been net sellers of shares from the early 1950s for nearly all of the period up to the 1980s before returning to the market in very large numbers subsequently. The proportion of adults owning shares directly rose from seven to 16 per cent between 1980 and 1994 (Davies & Peacock, 1997, Tables 4.10, 4.11 & 4.12, 109-113). Foreign persons and institutions owned 32 per cent of shares by market value in 1995. It is unlikely that the figure would have been as high in 1952. Unfortunately, Wheelwright did not identify 'foreign' owners as separate category including these owners within his 'personal' and 'nominee' categories. The growth of institutional owners is unambiguous. In 1952, Wheelwright's companies and financial institutions, including nominee companies, held just over a quarter of issued shares. The data collected by the Australian Stock Exchange for 1995 shows that these same institutions held 44 per cent of the market value of shares. The life offices and superannuation funds were the largest single group with nearly a quarter of the market value.

Table 3: Ownership of shares by individuals, companies and institutions, 1952 and 1995

Owner	1952 [per cent]	1995 [per cent]
Households/persons	75.6	22.8
Rest of world	-	32.0
Companies	15.5	8.8
Life & pension funds	-	23.8
Banks & other	-	11.0
All financial	8.9	-
Government	-	1.5

Source: Wheelwright, 1957, Table III C, 46; Davies & Peacock, 1997, Table 4.11, 110.

The importance of institutional investors arose in part because of changes in the government policy towards funding old age benefits. For more than three decades after World War II tax funded means tested pensions were the principal form of aged social security for most Australians. Superannuation funds were the preserve of high-income professionals and government employees. By the mid-1980s a three per cent superannuation contribution by employers had become part of many wage awards. Superannuation contributions by both employees and employers became universal from 1991. Between 1987 and 1994 the proportion of all employers involved in providing superannuation rose from 42 to 92 per cent. Funds managers were the recipients of significant inflows of funds, and the weight of shares in

their expanding balance sheets rose from around 20 per cent in the early 1980s to more than 35 per cent in the mid-1990s (Edey & Simon, 1996, Tables 2, 7 & Fig. 4, 16).

The rise to prominence of institutional investors as shareholders in the past decade and a half (Stapledon, 1996, 25-29 & 157-65) has altered the system of corporate governance within Australia. The funds managers have stronger incentives to monitor the corporations in which they have invested than do individual shareholders. They also have more specialized resources to devote to monitoring, privileged access to information resulting from the larger exposures and they can exert pressure to alter behavior at lower cost. There have been a number of highly publicized cases where action by individual institutions or the Australian Investment Managers' Group (AIMG), a grouping of the 40 largest funds, have forced changes in the personnel of boards and at senior executive (Stapledon, 1996b, 189-99). While informed commentators such as Jennifer Hill (1994) and Geof Stapledon (1996a & 1996b) have drawn attention to a range of legal and political factors that limit institutional shareholder activism, it can be argued that managers are under significantly more scrutiny now than they were previously.

The system of corporate governance was influenced to an important degree by the size and composition of the boards of directors, and by the statutory duties and liabilities imposed on directors. Boards of the largest Australian corporations averaged between seven and eight in number in 1959 and 1979, respectively (Stening and Wai, 1984, Table 1, 49), before shrinking to six in the early 1990s (Clifford and Evans, 1996, 62). The ratio of outside to executive directors ran at about two to one in favor of the former. Moreover, the position of chairman of the board was filled almost universally by an external director rather than the chief executive (Clifford and Evans, 1996, 62-64).

The relative constancy in size and composition contrasted to significant changes in the way boards were to behave. Australian corporation law reflected British practice. Before the introduction of Uniform Company Act in 1961 it was fairly permissive in that directors enjoyed wide discretions in what information they disclosed to the market other than an annual balance sheet and profit and loss account. Shareholders had few effective remedies to discipline the directors of the companies in which they had invested. A string of high profile corporate collapses throughout the 1960s, 1970s and 1980s brought pressure to bear for increased protection of shareholders' rights (Clarke, Dean and Oliver, 1997). Parliaments and stock exchanges progressively amended the law and listing requirements in ways that forced greater disclosure of information to investors [Industry Commission, 1991, Appendices G and H]. The pace of regulatory reform accelerated in the 1990s in an attempt to improve the practice of corporate governance (Tomasic and Bottomley, 1993; Hilmer, 1998; Clifford and Evans, 1996; Hughes, 1998; Bosch, 1993). These changes were motivated in part by the recognition that Australian corporations would be disadvantaged in raising capital in increasing global markets for equity and debt unless the country's system of corporate governance adopted the standards prevailing in the USA and Britain.

The amendment of black letter law regulating the behavior of corporations and their relations with equity markets, particularly for new issues, lagged behind the emergence of another powerful pillar of the system of corporate governance, a market for corporate control. Managers have a strong incentive to maximize profits for the shareholders if the failure to do so would result in the loss of their jobs after acquisition. For a market for corporate control to operate effectively it must allow hostile bids to be made and succeed. Shareholders must be informed of any bid to acquire the company. Before the mid-1950s Australian company directors were under no obligation to reveal that a bid had been made (Merrett and Houghton, 1999), although the Melbourne Stock Exchange suggested a voluntary code of disclosure in 1956 [381]. It was not until the Eggleston Committee's 'takeover code' was incorporated in the Uniform Companies Act in 1970 that corporations were compelled to inform their shareholders of the identity of a bidder, the terms of the bid and that shareholders were given reasonable time in which to make a decision (Maxwell, 1982). One commentator, described the regulation of takeover bids in Australian before 1981 as 'rudimentary' (Austin, 1993,144)

Despite the lack of protection offered to shareholders of both acquirers and acquirees, mergers and acquisitions were frequent occurrences throughout the 1950s and 1960s (Bushnell, 1961; Stewart, 1977). Most of these were friendly affairs such as the amalgamation of the pastoral companies Elder Smith and Goldsborough Mort in 1962 where shareholders were invited to rubber stamp a decision previously negotiated between the two boards of directors (Manning, 1970, 29-38). Acquisition of smaller, often unlisted, companies by larger listed ones was commonplace. Most of the purchases were paid for with stock or a combination of stock and cash rather than by cash (Bureau of Industry Economics, 1990, Table A3.7, 29). Hostile mergers were still few and far between before the 1970s. The acquisition of Drug Houses of Australia by the local subsidiary of the British 'raider', Slater Walker Securities, in 1969 (Raw, 1977, 247- 8) and the TNT raid on Ansett Transport Industries in 1972 (McGuinness, 1972) signaled what was to come.

The key change in the operation of a market for corporate control was the willingness of financial institutions to provide funds to the 'raider' taking the assets of the target as collateral. A powerful harbinger of change was the willingness of a leading local bank and large insurance company to bankroll the greater part of John Elliott's successful raid on Henry Jones IXL in 1972 (Hewat, 1988, 82-85). Other non-bank financial institutions were less cautious in providing funding for on market raids. Foreign banks, denied a banking license before the deregulation of the Australian financial system in the early 1980s, entered the market with representative offices and as 'merchant banks'. The latter, in particular, provided funds and acted as advisors for mergers and acquisition (Wallace, 1993). Deregulation, especially the end of exchange controls, gave local financial institutions and corporations unprecedented access to international debt and equity markets. A merger frenzy occurred in the 1980s as debt laden 'entrepreneurs' mounted raids and counter raids on the country's largest corporations (Sykes, 1994). Bids were launched against one in every ten listed corporations every year between 1983 and 1988 (Bureau of Industry Economics, 1990, Table A3.3, 27).

Access to finance transformed the effectiveness of a market for corporate control throughout the 1980s and 1990s. Bidders, whether they are other corporations or managers seeking leveraged buy outs, could search for finance in both domestic and international markets. Australian corporations exploited funding options offshore issuing bonds denominated in foreign currencies and listing on foreign equity exchanges. The breadth and depth of the domestic capital market was transformed after deregulation, not the least by the ability of Australian-based banks to fund their activities with foreign liabilities (Merrett, 1998; Merrett, 2002).

Australian corporations altered their funding arrangements in the 1980s becoming more heavily geared (Lowe and Shuetrim, 1992; Dempster, Howe and Lekawski, 1990). The ratio of debt securities issued by corporations to equity ratio rose from 0.47 in 1975-79 to 0.68 in 1985-89. A broader measure of debt including borrowings from financial intermediaries produced a ratio to equity of 1.2 over the period 1989-93 (Reserve Bank of Australia, 1997, Table 3.27). A sustained rise in asset prices over the decade made borrowing easier. Debtors had more effective remedies than shareholders to discipline managers. Managers had a strong incentive to meet debt repayments otherwise they lost their jobs and reputations as creditors liquidated the firm's assets. However, the operation of the system of corporate governance was undermined as information asymmetries gave rise to opportunistic behavior by debtors (Lowe and Rohling, 1993). Many creditors, particularly financial intermediaries, were unable to effectively monitor or discipline wayward corporations. As the decade progressed a number of the most prominent entrepreneurs were trading in assets rather than generating strong cash flows from business operations. The break in asset prices after the stock market crash in October 1987 and the collapse in property prices soon after brought distress to many firms who could no longer meet their interest obligations or raise fresh capital. Twenty of the more adventurous debt laden corporations collapsed with total losses of about \$20 billion, while Australian financial institutions wrote off more than \$28 billion in losses resulting from loan defaults up to 1993 (Sykes, 1994, Tables 17.1 and 17.2, 571 and 573).

During this time, the system of corporate governance was more robust than some commentators have suggested (Sykes, 1994, 1-32 and 569-93; Clarke, Dean and Oliver, 1997). Despite the highly publicized losses and gross deception practiced by some corporations in the 1980s, a number of the worst offenders fled the country or were sent to jail, badly managed firms were penalized insofar as they had to pay a higher price for new capital, were broken up through management buyouts (MBOs) or were liquidated. A consequence of the large loan defaults was that banks, partly in response to pressure from the central bank, significantly improved their internal risk assessment and monitoring procedures (Thompson, 1996). The whole system of prudential regulation was overhauled in the late 1990s (Gray, 1997). Greater information became available to investors about the standing of some corporate debtors as a secondary market for bonds developed (Financial System Inquiry Report, 1997, 159-61; Reserve Bank of Australia, 2001).

Corporations restructured their balance sheets in the 1990s to reduce gearing levels. Equity markets became increasingly important as a source of funds (Gizycki and Lowe, 2000). The size and liquidity of the domestic equity market was significantly enlarged in the 1990s by the demutualization, including life offices and building societies (Reserve Bank of Australia, 1999) and, more importantly, by a massive sell off of government owned business enterprises (Reserve Bank of Australia, 1997; Walker and Walker, 2000, Table 2.1, 20-24). The Reserve Bank estimated that the privatized government businesses generated about ten per cent of the market capitalization of the Australian share market in 1997, and was an important contributory factor in boosting the proportion of persons holding shares from ten to 20 per cent between 1991 and 1997 (Reserve Bank of Australia, 1997, 12). Over that same period, the ratio of market capitalization of listed equities to GDP had risen from 44 to 87 per cent.

The market for corporate control through the operation of equity markets was strengthened in the 1990s by a number of factors. Funds managers became increasingly important owners of equities, as discussed above. As most Australian employers became contributors to superannuation funds competition between funds managers increased. In the battle for custom, funds managers closely monitored the performance of the corporations in which they had invested and based investment decisions on short-term results. The use of analysts by stockbrokers and funds managers improved the quality of the advice guiding their own investments and the advice given to clients. Techniques of evaluation became increasingly sophisticated including less reliance on accounting data and more about cash flows or economic value accounting. The Australian Shareholders Association and Australian Investor's Association vigorously promoted the rights of individual shareholders, reinforcing the presence of funds managers in the market. The reforms in corporations and securities laws mentioned above, together with privatizations and demutualizations, superannuation policies and vigilant funds managers formed a virtuous circle supporting the development of a deeper and more liquid equities market.

The effectiveness of the threat of takeover as a mechanism for aligning the goals of managers and shareholders has been compromised to a degree by a number of factors. Firstly, during the 1980s corporations became increasingly adept at pre-empting or defeating bids. Defensive actions included locking in the share register, and issuing misleading information to the market and manipulating share prices (Austin, 1993, 176-83). Frequent recourse to the courts by firms under attack increased the costs and lengthened proceedings. Bidders also frequently tested the jurisdictional powers of regulatory bodies. Reforms in corporations and securities law have attempted to address these issues. However, the use of market transactions to align incentives was discouraged by the high costs of mounting a hostile bid and the uncertainty of the outcome. Skeptics of market-based remedies note that there is little empirical evidence linking the prevention of under performance and hostile bids (Stapledon, 1996b, 14-18). Moreover, government regulation of foreign investment both through legislation limiting foreign shareholding in banking and media and more generally through the deliberations of the Foreign Investment Review Board provides a further defense to incumbent managers in a number of industries. Furthermore, the Trade Practices Tribunal, now operating as the Australian Competition and Consumer

Commission, has the discretion to block acquisitions that would result in a lessening of competition. As many industries are dominated by a handful of large firms the operation of competition policy limits the possibility of horizontal mergers (Austin, 1993, 148-9).

In one last respect, the system of corporate control has been strengthened in a decisive fashion. Owners have increasingly sought to align the goals of managers and directors with those of shareholders by offering incentive contracts that link remuneration to performance. The data shown in Table 4 indicates the dramatic changes in the composition of the remuneration packages of CEOs of 49 of Australia's largest corporations that subscribe to the executive reward database managed by the Hay Group (O'Neill and Iob, 1999, 65-67). Similar shifts were evident in the compensation packages of the next two levels of executives. Stock options and employee share plans have become an increasingly common feature of compensation in Australian businesses. The issue of the amount and growth of executive remuneration has been a matter of controversy in Australia as elsewhere (O'Neill, 1999, 2-6). Payments to executives, and directors, of large corporations have risen significantly faster than average earnings over the past 15 years. Concern has arisen about a number of issues including who within the corporation determines the size of the packages. Debate also continues as to whether there is a link between the shift to incentive payments and subsequent profitability. Holland, Dowling and Innes' longitudinal study of a sample of 26 corporations over 1988-99 (2001, 47-53) found no statistically significant correlation between changes in CEO pay and stock market performance.

Table 4: CEO remuneration package, 1987-98

Per cent	1987	1990	1998
Fixed pay	90.5	81.7	50.4
Short term incentive	3.2	5.0	14.5
Long term incentive	6.3	13.3	35.2

Source: O'Neill, 1999, Table 2, 11.

While the results of this small sample do not provide support for strong incentive effects in the short term, the potential impact of using incentive contracts to align goals should not be lightly dismissed. The markets, institutional managers, credit rating agencies, analysts and the business press were more judgmental of poor corporate performance than was the case in the early 1970s, and the regulatory changes provided them with more remedies to discipline under performing managers than had been the case in the past. In the longer term, corporations need external sources of funds to finance growth. Markets rewarded those well-performing firms with capital at lower cost. While Australian firms had access to international markets in their search for capital they now had to satisfy both foreign and domestic markets that they could generate a sufficient rate of return on the capital employed. Both foreign and domestic investors could choose to diversify their portfolio across many national markets. Integration of financial markets compelled Australian corporations to offer a rate of return equal to those in other countries. A study by Dunk and Kilgore [1998] suggests that manager's choice of R&D investments were heavily influenced by short term profit considerations.

Microeconomic Reform and International Competitiveness

Deteriorating macro-economic performance was the motivator for the new policies introduced by the government from the 1970s onwards. The oil price shocks of the early and late 1970s stalled growth, and drove up unemployment and inflation in Australia as they did elsewhere [Norton, 1982]. However, these sharp recessions overlaid more deep-seated and longer-term problems. Australia had been sliding down the list of per capita incomes in the OECD group of countries since the end of World War II (Dowrick and Nguyen, 1989). It had been plagued by a comparatively slow growth of per capita incomes, poor productivity growth and a recurrent balance of payments problem. A widening deficit in the balance of trade resulted from an adverse movement in the terms of trade for Australia's narrow

range of resource-based exports. The Keynesian-style mix of fiscal and monetary policies employed by the authorities since the late 1940s was unable to combat either the rising unemployment or inflation in the 1970s, or to address the increasingly adverse external position.

The Australian Labor Party, under Prime Minister Hawke and Treasurer Keating, embarked on a policy of radical economic reform after taking office in 1983 (Emy, 1993). This thrust was continued by the Liberal-National Coalition government that replaced it at the 1996 election. In brief, most of the protective and regulatory apparatus that had shielded Australian product and factors markets from domestic and international competitive pressures since before World War I were removed. Trade barriers on manufactured imports were reduced from an average 23 per cent, the highest in the world in 1970, to a projected five per cent by 2001 (Anderson and Garnaut, 1987, Table 2.1, 7). The financial system was deregulated in the early 1980s, with the removal of capital controls and the floating of the Australian dollar occurring in 1983 (Grenville, 1991; Perkins, 1989). Important reforms also occurred in the labor market. The old system of wages and conditions being determined by tribunals applying awards after hearing submissions from unions, employer peak bodies and governments on an industry-wide and national basis was freed up insofar as workers and employers increasingly bargained at an enterprise level (Dawkins, 2000). Further reform included the massive sell off of government business enterprises discussed above.

These sweeping changes in the 'rules' under which Australian businesses have operated in the last 25 years have played an important part in driving the reallocation of resources between industries or structural change.² Their effect on the decisions made by corporations will be reinforced or negated by market-related forces including technological change, changes in consumption patterns, trade and global specialization, and resource discovery and depletion (Productivity Commission, 1998, Box 1.1, 2). The combination of these regulatory and market forces generated faster rates of structural change in the 1980s than 1970s; broadly a reduction in the share of resources allocated to rural and manufacturing activities and a growth in services. The shrinkage of the rural and manufacturing sectors was accompanied by a reallocation within each towards import competing and export activities. Moreover, the pace of structural change in Australia was faster than that experienced by the OECD countries over both the 1970s and 1980s, while it was slower than that experienced by industrializing Asian economies (Productivity Commission, 1998, 4-14).

The net result of the various drivers of structural adjustment was that the absolute and comparative advantage enjoyed by Australian producers in a range of industries vis-à-vis the rest of the world shifted in their favor. A short hand measure of the greater effectiveness with which resources were being used was the prolonged and rapid rise in productivity over the 1980s and 1990s (Gruen, 2001; Quiggin, 2001). In terms of the schema developed by Rugman and Verbeke (1990) Australian corporations were able to exploit enhanced country specific advantages (CSAs). Within these more competitive domestic markets firms that learnt to develop firm specific advantages (FSAs) could build a sustainable competitive advantage operating abroad. As noted in the introduction to the paper, the ratio of goods and services exported to GDP rose significantly as did the stock of outward FDI to GDP. Manufacturers, once the most heavily protected sector in the economy, dramatically improved its trade performance (Sheehan, Pappas and Cheng, 1994; McKinsey & Company/Australian Manufacturing Council, 1993). Data from the longitudinal study of Australian business covering the second half of the 1990s show that about 13 per cent of all manufacturers and more than half of large manufacturing businesses³ exported. Of those manufacturers that exported, nearly two-thirds did so regularly. Industry input-output data shows that nearly a fifth of the 56 industry sub-groups had increased their international competitiveness between 1995 and 19974 (Reserve Bank of Australia, 2001, 6-7).

Incentives and Internationalization

Policy advice received by Australian governments over the past 25 years from within its bureaucracy, from inquiries reviewing industry regulations, think tanks and academics advocating reform had a universal theme: competitive markets produce superior economic outcomes to those where the government intervenes. Economists espousing free market ideas rose to prominence within the federal bureaucracy, particularly in the key areas of the Treasury and central bank. They were instrumental in providing the intellectual ammunition for the abandonment of Keynesian-style macro-economic management and industry-based interventionist policies and the embrace of 'small' government and free markets (Whitwell, 1986; Schedvin, 1992; Pusey, 1991). An implicit assumption of the policy advice was that businesses would adjust to the new environment, taking advantage of lower costs and wider markets, in a fashion that would maximize their profits. It ignored the central issue of corporate governance: that problems of agency permit managers to act in ways that may lead to sub-optimal outcomes for the owners of the business. A more robust system of corporate governance was needed to align the objectives of managers and shareholders through a combination of disciplinary mechanisms that rested upon flows of more timely and transparent information to the market, and increased use of remuneration incentives.

The contention of this paper is that there was a causal connection between the shift from a weak to a stronger form of corporate governance and the increased internationalization of Australian business. The rapid transition from a heavily protected to a more open market posed new challenges to managers. For many, facing foreign competition in domestic markets and seeking opportunities in foreign markets was a new experience (Merrett, 2001, Merrett, 2002a, Merrett, 2002b). Managers lacked the skills to make sense of and operate in a new, more complex and uncertain environment. Initiating foreign operations involved higher transaction costs in finding counter parties with whom to trade, and posed higher costs in writing, monitoring and enforcing contracts. Agency problems arising from information asymmetries between managers and shareholders allowed managers to undertake adverse selection by under investing in the higher risk-return activities abroad.

The swift change in policy regime left a population of businesses that had little experience in international operations exposed. Numerous reports sponsored by the government in the 1980s identified the difficulties firms were facing and the government stepped up its efforts to assist exporters, particularly through devoting greater resources to Austrade and the Export Finance and Insurance Corporation (Access Economics and The Allen Consulting Group, 1991; Committee for Review of Export Market Development Assistance, 1989; Foreign Affairs and Trade, 1995). The costs and difficulties of learning to internationalize were considerable. As the research of the internationalization process school (Johanson and Vahlne, 1977, Welch and Luostarinen, 1988) demonstrates, firms were most likely to be successful if they began on a modest scale and advanced their international involvement incrementally. Accumulated experience could be leveraged enabling entry of more distant markets, both in a geographic and psychic distance sense, and by entry modes that necessitated greater resource commitments and changes in organizational form.

Managers required stronger monitoring and motivation to undertake international activities, particularly when doing so required significant investments in resources and the development of new skills. Agency problems were exacerbated by the environmental complexity confronting managers and owners. Information asymmetries increased as the manager's knowledge base of diverse markets and cultures became wider and more specialized. Information processing was carried out by top management teams whose actions and efforts, both subjected to potential adverse selection and moral hazard, were increasingly difficult for directors and shareholders to observe. In the US, with its strong market-based corporate governance system in place, Sanders and Carpenter's (1998) study of 258 of the Fortune 500 list found that the governance structures within those firms had been adapted to overcome agency issues inherent in their internationalization strategies. There was a positive and significant relationship between the degree of internationalization and long term financial incentives offered to the CEO.

Moreover, the size of the top management team and the composition of the board, particularly the separation of the position of CEO and president, was a function of the size of the firm and its international involvement.

The nub of the argument is that the policy reforms altered costs and prices in Australia in ways that made it possible for many businesses in the traded goods sector to become internationally competitive. However, firms were most likely to respond positively to these new market signals when managers had strong incentives to do so. Small and medium sized businesses, where nearly all of the equity is the hands of the owner-managers or their families (Industry Commission, 1991, Table 9.1, 140), were particularly active in becoming exporters and undertaking direct investments offshore (McKinsey & Company/Australian Manufacturing Council, 1993; Industry Commission/Department of Industry, Science and Tourism, 1997, Tables 3.154-3.168, 120-29). In the early 1990s, smaller firms were outperforming the top 50 firms in terms of cutting costs and building profits. The *Business Review Weekly* reported 'the small to medium-sized businesses were also quick to adapt to changing markets in Australia and, in many cases, to tap into small, high-margin markets in Asia...' (*Business Review Weekly*, 1992, 60).

Larger firms, whose day-to-day operations were in the hands of managerial hierarchies, also became increasingly internationalized. Lists of the 500 largest exporters and 50 firms making the biggest foreign direct investments closely matched those appearing in the lists of the largest businesses in Australia (*Business Review Weekly*, 1995, 1996a and 1996b). In the absence of any official longitudinal or panel statistics about firm export and FDI activities before the mid-1990s, recourse must be made to qualitative data usually on a firm-by-firm basis. A number of illustrations to be presented below suggest that the combination of the changes in the broad corporate governance system, often combined with a change in ownership of a business, played a part in redirecting the strategy of these businesses towards internationalization.

Australia's corporate landscape has been redrawn by the mergers, acquisitions and liquidations of the past two decades. Many of the key players in the merger and acquisition processes became very wealthy by holding large blocks of equity in the company used to acquire others. Complex company structures, such as those used by Rupert Murdoch and Alan Bond, enabled ownership and control to be exercised through family owned private companies and the use of trust companies. On the other hand, John Elliott and his top management team received large bonuses linked to movements in the share price (Hewat, 1988, 157-8).⁵ Key decision makers in many corporations, executive and non-executive directors, had their wealth directly linked to the market value of companies in which they had a large equity exposure. There was a substantial shift towards an alignment of incentives for managers and owners.

The drive for profits within Australia was continued overseas. Access to debt finance allowed John Elliott's Elders IXL and Allan Bond's Bond Corporation to take control of nearly all of Australia's brewing assets in the early 1980s. Both then embarked on a far more aggressive program of international expansion, particularly into Britain, than had been pursued by previous managers of those breweries (Merrett and Whitwell, 1994, 162-73; Merrett, 1998, 242-43). Within a decade Australian brewers had become global players. Rupert Murdoch's News Corporation, one of Australia's three family owned media giants, expanded beyond its Australian base in 1968 with the purchase of the British newspaper, the News of the World, to become one of the world's largest media firms acquiring a string of overseas acquisitions of newspapers, magazines and book publishing businesses, Twentieth Century Fox film studio, a string of TV stations in the US and satellite operations for pay TV (Norton and Willcocks, 1993; Economist, 2001). Frank Lowy, who owns 45 per cent of the equity in Westfield Holdings, has invested heavily in shopping centers in the United States. Its recent deal with Rodamco North America has made Westfield Holdings the second largest owner of malls behind Simons Property Group (Australian, 2001).

A stronger commitment to a strategy of internationalization was also evident in the previously mutualized financial institutions and government owned business enterprises. Nearly all of Australia's life offices demutualized. A motivation for the directors of the AMP, the largest firm, for it to follow the suit of other now demutualised firms was to increase pressure on their managers to lift performance. (Blainey, 1999, 329). Since demutualisation was effected in 1998 the AMP has embarked on a strategy of greatly expanding its international product range and extending into markets beyond New Zealand and the United Kingdom (<http://www.ampgroup.com.au/>). Likewise, the scope and scale of the international operations of Qantas (1995/96), the Commonwealth Bank (1992-98) and Telstra (partial privatisation 1997/98) have all increased significantly since their privatisations (<http://www.qantas.com.au/company/history>; Stace, 1997, 167-94, Merrett, 2002b).

The fate of BHP, one of Australia's largest corporations that produced steel, coal and petroleum, over the last 20 years mirrors the increasing effectiveness of the corporate governance system. BHP was attacked by raiders during the early 1980s but escaped in part through the intervention of John Elliott (Haigh, 1987). Thereafter, the market was rife with speculation about the possibility of breaking the poorly performing corporation up into its constituent parts, particularly floating off its successful petroleum division. A series of disastrously bad investment decisions in Australia and abroad saw the firm suffer huge losses in the 1990s. Ultimately, many of the board and nearly all the senior management team lost their jobs. A new CEO was appointed in 1998, Paul Anderson, an American from Duke Energy, the first outsider in the firm's 113 year history. Within a few years BHP had merged with the South African resources giant, Billiton, to become the dual listed BHP Billiton. Market disciplines of the corporate governance system had wrought extraordinary changes within the firm, forcing an overhaul of strategy and decision making processes. Moreover, the directors sought to align the goals of managers with those of the shareholders through the incentives of generous remuneration packages that were linked to share prices.

Conclusion

More Australian businesses are competing in foreign markets than ever before. To a large degree this reflects their adaptation to government policies begun in the 1980s promoting market reform within Australia and the liberalization of trade and investment policies across the globe. Market-based prices facing businesses that were increasingly influenced by 'world' prices prompted a significant reallocation of resources between and within industry sectors. The heavy fall in the value of the Australian dollar against other currencies has assisted exporters but would equally have increased the cost of acquiring foreign assets by direct investment.

This paper argues that changes in the system of corporate governance operating in Australia increased the incentives to managers to respond more positively than they otherwise might to the opportunities offered by the new environment. The rush of small and medium enterprises, where agency issues were attenuated by the owners managing the businesses, to adopt internationalization strategies suggests an improvement in Australia's comparative advantage in a range of manufacturing and service activities. Going abroad made life more difficult for managers as additional resources and new skills were required, and the foreign environment was more complex and often more turbulent than at home. Agency issues allowed managers discretion in their choices of strategy. These problems were greatest in larger organizations, and those with mutual forms of ownership and those owned by governments. A combination of broader and more powerful market-based disciplines and the wide use of incentive remuneration contracts, together with demutualisation and privatization, moderated agency issues and reasserted ownership rights. With a greater focus on performance and shareholder value, managers were increasingly willing to adopt an internationalization strategy.

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Notes

- 1 Changes in the definition of FDI post 1985, including lowering the threshold of equity holdings that qualify as being FDI from 25 to 10 per cent and valuing equity at market rather than book values, make comparisons before and after 1985 problematic (Australian Bureau of Statistics, 1987, 89-90).
- 2 Their impact on the operation of the economy, and the associated distributional outcomes, is still a subject of intense debate (Quiggin, 1996; Argy, 1998).
- 3 More than 100 employees (Industry Commission/Department of Industry, Science and Tourism, 1997, Table 3.166, 128).
- 4 Industries whose ratio of exports to sales and where imports share of market supplies crossed above the 10 per cent threshold (Reserve Bank of Australia, 2001, 6-7).
- 5 Ultimately, Elliott and his top management team attempted to buy out the other shareholders. Their privatisation vehicle, Harlin Holdings, failed as the dividends from the Elders IXL shares it purchased could not cover its debt repayments.