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Effect of government share ownership on corporate risk taking: Case of the United Arab Emirates☆

Md Hamid Uddin

College of Business Administration, University of Sharjah, P.O. Box 27272, Sharjah, United Arab Emirates

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ABSTRACT

If government holds ownership in corporate firms, principal–principal conflict may arise between government and private owners. I argue conflict aggravates when government is minority owner, because the powerful minority owner (government) exerts political pressure on the majority private owners to achieve government objectives. Hence, government minority firms are likely to be conservative in risk taking due to the existence of principal–principal conflict. I provide supporting evidence from the United Arab Emirates, which has the highest record of government ownership in stock exchange listed firms of any country. However, the relationship between government ownership and risk taking is a non-linear U-shaped.

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1. Introduction

Government or state corporate ownership is found across the world (Claessens et al., 2000; Dewenter and Malatesta, 2001; Boubakri et al., 2013a), but this phenomenon is especially widespread in the United Arab Emirates (UAE), where government maintains a share ownership in 48% of all the stock exchange listed firms (Uddin et al., 2014). This is perhaps the highest documented record of government ownership in the stock market listed firms of any country. Different studies report that the government share ownership negatively affects the corporate performance in different countries such as Singapore, Malaysia, China, Turkey, India, and Jordan (Ang and Ding, 2006; Feng et al., 2004; Najid and Rahman, 2011; Tian and Estrin, 2008; Sun and Tong, 2002; Gursory and Aydogan, 2002; Gupta, 2005; Zeitun and Tian, 2007). These researchers mainly suggest that a negative relationship between the government ownership and firm performance is the result of the agency problem. Interestingly, Uddin et al. (2014) document that government ownership has generally a positive effect on the corporate performance in the UAE, which is inconsistent with the evidence of the other countries. This anomaly motivates me to examine the dynamics of the relationship between the government and the corporate firm in which the government maintains an ownership.

Given the above background, I believe that the government, as the most powerful political institution of a country, having an ownership in a firm directly influences its risk-taking decisions (henceforth corporate risk taking), which determines the performance, survival, and growth of that firm in the competitive market environment (Nakano and Nguyen, 2012; Memili et al., 2010; Gilley et al., 2002; Bromiley, 1991). The government influences corporate risk taking decisions because it has

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E-mail addresses: iba_hu@yahoo.com, mduddin@sharjah.ac.ae

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social, political, and economic interests in the firm (Wright et al., 1996; John et al., 2008; Boubakri et al., 2013a; Uddin, 2014). The social and political interests are mainly related to public employment, social stability, and political control over the economy, whilst the economic interests are related to supplementing government revenue by additional dividends incomes, capital gains, and corporate taxes (Uddin, 2014). Since the stock market listed firms usually maintain a diffused ownership structure, the government works with other shareholders to develop a governance mechanism that is supposed to align the interests of different shareholder groups (Sur et al., 2013). However, I assume that alignment of all shareholders' interests is difficult because of the diversity of interests. Consequently, the major and/or powerful shareholders' interests ultimately determine the corporate risk taking behavior of a firm. Since government is politically the most powerful shareholder regardless of the level of ownership, the corporate risk taking of the firm with a shareholding of the government will reflect the interests of government all else the same. Therefore, a relationship between the government share ownership and corporate risk taking is expected.

Based on a cross-country sample, Boubakri et al. (2013a) recently reported that government ownership has a negative effect on corporate risk taking. This incites me to think if the government ownership inevitably discourages a firm from taking more risks then why does the study of Uddin et al. (2014) find that the UAE government linked companies (GLC) perform better than the firms without government links. Therefore, a new study on government ownership and corporate risk taking is undertaken based on the UAE data. The literature review shows that the firm owners, particularly the insiders, have both negative and positive incentives to undertake risky investments. The firm is conservative in risk taking if the government as an insider owner actively seeks to achieve its social and political objectives, whereas the firm liberally takes risk if the government gives priority to the economic objectives and provides active support to the firm. Therefore, government shareholding can have either a negative or a positive effect on the corporate risk taking, subject to the priority of government objectives. Given this knowledge, based on the theory of principal–principal conflict, I analyze that government gets into disputes with the private shareholders if the majority share goes out of the government hands. This occurs due to divergence of the interests in the firm maintained by the minority government and the majority private owners. The discord between them aggravates when the powerful minority, being the government, exerts pressures on the majority to achieve the government objectives, and in the state of high conflict, the government minority firm will be conservative in taking on risky projects. However, when government maintains the majority ownership, the conflict of interests between the government and private owners is less, and the risk taking decisions can be made more easily if needed for the country, given the circumstances of the economy. Finally, I hypothesize that the relationship between the level of government share ownership and corporate risk taking will exhibit a non-linear U-shaped pattern instead of linearity.

Using 10 years' data from 108 firms listed on the Dubai Financial Market (DFM) and Abu Dhabi stock exchange (ADX) and four alternative measures of corporate risk taking, I find that the identity of a firm as GLC (firms having government ownership) does not significantly affect its corporate risk taking. Compared with the non-GLCs (firms having no government ownership), the GLCs take more risk when government maintains full control over the firm by holding more than 50 percent ownership. Finally, the regressions identify a significantly quadratic relationship between government ownership and corporate risk taking, in which the first order effect of the government ownership on risk taking is negative but the second order effect is positive, confirming the test hypothesis. I confirm the results by conducting additional tests that examine the robustness. As a whole, the effect of government ownership on the corporate risk taking behavior in the UAE is not consistent with the only available evidence recently provided by Boubakri et al. (2013a) based on the cross-country data. The cross-country study reports that the government share ownership monotonically leads to lower corporate risk taking by the firm, whereas the current single country study shows that the propensity of corporate risk taking initially declines with the increase in government ownership but rises if the government strongly participates in the firm ownership with full control on the firm.

The findings of my study have several implications. First, a new corporate governance mechanism can align the interests of the government and private owners of the GLCs. Second, the GLC managers should make value-adding corporate decisions with a careful balance of the interests of the government and private owners. Third, the investment managers should select the GLC stocks with more analyses on the future growth prospects of the firms having government ownership. Fourth, privatization without effective transfer of the control of firms to the private shareholders will not be successful to improve firm performance due to the rise of conflict between the government and private owners. The results also suggest that majority or controlling government ownership of a firm is not to be considered bad if GLCs can be managed by the professional managers with a high standard of corporate governance and without political motive.[1] This study contributes to the literature by providing a new analysis to understand the behavior of the relationship between government ownership and corporate risk taking and by documenting the first single country evidence that the minority government share ownership has a negative effect on the corporate risk taking, but the majority government ownership has a positive effect on risk taking. I believe that the UAE evidence is an important addition to the literature, because this country has distinct characteristics that justify a new study about the effect of government ownership on corporate risk taking.

The UAE is the second-richest country in the world in terms of the value of total sovereign wealth funds invested ($975 billion) in real and financial assets across the world, including the home country (Source: *Gulf Today* May 7, 2014). As reported

[1] In the UAE, the majority of CEOs of the GLCs do not play a dual role as the board chairman (Uddin et al., 2014). An ongoing investigation shows that many of these CEOs are professionally trained people recruited from global talent.

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