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External competition and internal governance on stock options plans: Evidence from Taiwan

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ABSTRACT

This study is to investigate the influences that external product market competition and internal corporate governance mechanisms have on managerial incentives. In this study, the values of employee stock options are used to measure managerial incentives. The findings show that excessively large boards, CEO duality, cross-holding, and a pyramidal structure achieve a positive correlation with managerial incentives. In addition, the presence of independent directors also increases the stock options values of managers. The independent directors possible overlook governance functions to increase managerial incentives, and they focus more on equity incentives. Furthermore, the relationship between product market competition and managerial incentives is nonlinear, which implies that in less competitive markets, an increase in competition stimulates firms to increase their managerial incentives. By contrast, in highly competitive markets, an increase in competition stimulates firms to decrease their managerial incentives.

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1. Introduction

Ownership and control are separated in contemporary corporate organizations. Subsequently, the incompleteness of employee contracts, information asymmetry, and moral hazards that manifest because of this separation cause manager–owner (shareholders) conflicts of interest (Jensen & Meckling, 1976). To resolve such conflicts of interest, relevant governance mechanisms can be established to reduce the agency problems between managers and owners and protect shareholders' interests.

The governance mechanisms include internal corporate governance mechanisms (hereafter referred to as *internal mechanisms*), which entails board structures monitoring managers, and external governance mechanisms such as market competition (hereafter referred to as *external mechanisms*). Moreover, the “Agency Problem II” proposed by Villalonga and Amit (2006) wherein controlling shareholders seek private benefits at the expense of minority shareholders can be mitigated through the implementation of effective governance mechanisms.

The agency costs are typically reflected in the design of contracts between managers and owners. Managerial incentives can be used for reducing agency problems; however, these incentives may also be the source of such problems. We discuss the influences that the board-related characteristics of internal mechanisms and the product market competition of external mechanisms have on managerial incentives. Economic theory stipulates that product market competition alleviates ‘quiet life’ of management. Specifically, in a competitive market environment, managers typically devote their efforts to ensure corporate survival, preventing severe agency problems from occurring even without the presence of appropriate monitoring mechanisms.

The yardstick competition hypothesis indicates that product market competition can reduce information asymmetry between inside managers and outside shareholders because the outside shareholders can easily benchmark a firm's performance to the performance of competitors (Hart, 1983; Shleifer, 1985). Schmidt (1997) shows that intensive competition increases the default risk and liquidation risk of a firm and thereby reduces the agency conflicts between managers and shareholders. Shleifer and Vishny

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(1997) further show that competition reduces the agency costs of free cash flows because competition discourages managers to invest in negative NPV projects. Allen and Gale (2000) argue that product market competition can either serve as a monitoring mechanism or a corporate governance mechanism to reduce agency conflicts. Bertrand and Mullainathan (2003) show that competition eliminates the “quiet life” to reduce the input costs, overheads, and wages.

However, the relationship between product market competition and managerial incentives remains unclear, and previous studies have yet to concede as to whether this relationship is positive or negative. Some have contend that because managers have to devote their efforts in highly competitive markets, enhancing the attractiveness of managerial incentives is necessary, which suggests that competition positively influences managerial incentives. Others argue that because managers must devote their efforts to ensure corporate and personal survival in highly competitive markets, attractive managerial incentives are unnecessary, which suggests that competition negatively influences managerial incentive. Nevertheless, because the empirical results of previous studies have verified both arguments, the relationship between product market competition and managerial incentives remain ambiguous.

Schmidt (1997) argues that product market competition reduces the profit margin leading to lower firm profitability. Therefore, firms faced with intense competition are less likely to offer an attractive compensation scheme to motivate managers. Karuna (2007) shows that product market competition can either substitute for or complement managerial incentives. Competition can serve as a disciplinary mechanism to reduce the need for managerial incentives. Nevertheless, firms have to pay greater incentives to managers to motivate them in a more competitive market. Consequently, in a more intensely competitive market, firms might need to provide managers with higher allowances. The total effect of product market competition on managerial incentives is, thus, ambiguous.

Beiner, Schmid, and Wanzenried (2011) argue that the relationship between product market competition and managerial incentives is nonlinear depending on the absolute level of competition. Beiner et al. (2011) propose a business stealing effect and a scale effect to explain the relationship between competition and managerial incentives. The business stealing effect indicates that a positive relationship between managerial incentives and competition. The scale effect indicates that a negative relationship between managerial incentives and competition instead. During low competition, the scale effect dominates; whereas during high competition, the business stealing effect dominates.

Takeover threat is considered as an effective external mechanism. However, in certain markets that provide insufficient investor protection, takeover threat is unpopular or relatively weak. In addition to external mechanisms, internal boards of directors are crucial monitoring mechanisms. The function of a board of directors is to ensure that managers endeavor to maximize benefits for owners or shareholders and reduce agency problems. This study primarily investigates the influences of internal and external mechanisms on managerial incentives.

The most common types of managerial incentives include salary increases, bonuses, and employee stock options. Fixed salaries, one of the sources of agency problems, fail to effectively stimulate managers in devoting their efforts to enhance firm value and maximize shareholders' wealth. By contrast, stock options effectively link manager remuneration with a company's stock prices; thus, employee stock options are considered a favorable method for reducing the agency problems between managers and shareholders, especially in emerging economies without solid investor protection. There is little empirical evidence to demonstrate the effectiveness of employee stock options to motivating managers in economies with weak investor protection. Therefore, in the context of managerial incentives, we focus on the stock options value that managers can obtain to examine the influences of product market competition on equity-based managerial incentives.

This paper focuses on the Taiwan case because Taiwan is an emerging civil law country where takeover threat is weak. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) document that civil law countries do not provide investors with strong enough protection. Claessens, Djankov, and Lang (2000) show Taiwanese firms are also likely affiliated with pyramidal or cross-holding structures with the existence of controlling families or groups. Choy, Gul, and Yao (2011) characterize Taiwan as a country with high investor expropriation risk. Moreover, market competition is generally intensive in the emerging markets such as Taiwan. Faced with intensively competitive markets, managers have to devote more efforts and need motivations linked with performance.

This paper is other than Schmidt (1997), Karuna (2007), or Beiner et al. (2011). Schmidt (1997) is a theoretical paper and does not provide empirical evidence about the relationship between managerial incentive and product market competition. Karuna (2007) examines the relationship between managerial incentive and product market competition but does not document a nonlinear association between managerial incentive and product market competition. Beiner et al. (2011) indicate that there is still little empirical evidence on the relationship between managerial incentive and product market competition and investigate the nonlinear relationship between managerial compensation and product market competition based on a unique Swiss data set, a significantly more well-diversified equity structure than Taiwan.

Previous research focuses on Western economies, no empirical evidence ever examines the relationship between managerial incentive and product market competition in East Asian countries, economies with weak investor protection due to family control or group control through pyramidal or cross-holding structure. This paper contributes to the literature by filling this gap.

We find that a non-linear relationship between product market competition and managerial incentives, indicating that firms must use attractive incentives to stimulate managers in confronting external competitive environments at low competition level and that managerial incentives decrease with competition at high competition level. The managerial incentives in firms where the internal boards of directors demonstrate weak monitoring capacity (i.e., excessively large boards or CEO duality) are typically highly attractive, suggesting that managers are extremely likely to seek private benefits during the absence of supervision. The presence of independent directors positively influences managerial incentives, suggesting that independent directors favor stock options with benefits that are directly proportional to stock performance rather than salaries.

The remaining of this paper is organized as follows. Section 2 presents the data source and variable definitions. Section 3 discusses the descriptive statistics of our variables. Section 4 examines the industry characteristics related to competition. Section 5 presents examinations of the relation between managerial incentives and internal governance and the relation between managerial incentive and product market competition. Robustness checks are provided in Section 6. Finally, Section 7 concludes the paper.

2. Data source and variable definition

2.1. Data source

Our data cover all the listed firms in Taiwan over the period 1996.03 to 2012.12. Our sample period begins in 1996 because the

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