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# Foreign ownership mode, executive compensation structure, and corporate governance: Has the literature missed an important link? Evidence from Taiwanese firms

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ABSTRACT

We propose an alternate context-based extension to the agency theory-grounded explanation of foreign ownership mode choices proposed in the literature. Using a sample of Taiwanese firms investing in the greater China region over the 2001–2009 period, we show that both economic and non-economic factors influence the choice of foreign ownership mode. In addition, we document that higher institutional ownership percentages motivate Taiwanese firms to select shared ownership in the greater China region. Further, no long term compensation mix/ownership structure link is found. These findings run counter to a theory provided for foreign ownership mode choices of US based firms. Our findings provide support for the validity of stewardship and social capital theory, but not financial incentives-based agency theory, for Taiwanese firms investing in the greater China region.



## 1. Introduction

In a recent seminal paper, Musteen, Datta, and Herrmann (2009) introduce agency theory into the foreign entry mode literature. Using US firm-level foreign entry mode data from 1991 to 1998, they present evidence that firms prefer full ownership of their foreign operations when there is a high proportion of institutional owners or inside owners in its common equity portfolio. Furthermore, they also document evidence that if the CEO's compensation mix is biased toward long term performance, then there is a greater propensity toward full ownership.

The agency theory-based extensions to the foreign ownership mode literature presented in Musteen et al. (2009) readily apply to firms where corporate strategic decisions are primarily motivated by financial considerations. Higher proportion of long term options in their compensation mix persuades managers to assume greater economic risks (and hence the choice of full ownership over shared ownership) in their foreign entry mode decisions since they provide management with monetary benefits if they pursue long term oriented strategies. Similarly, firms with larger proportion of institutional investors opt for full ownership over shared ownership because they already are well diversified outside of their investments in the company, and hence can afford to assume greater economic risks. Musteen et al. (2009) also buttress their arguments using the link between corporate R&D investments and the proportion of institutional investments in the firm. They suggest that the fact that high levels of institutional ownership are positively correlated with corporate R&D spending is testimonial that institutional owners discourage strategies that reduce economic risks, allowing them to prefer full ownership. They also provide empirical support that higher levels of insider ownership motivate firms to seek full ownership for their foreign affiliates. They argue that "... when insider ownership is substantial, the financial interests of insiders and those of shareholders tend to converge..." (p. 326). Furthermore, they suggest that "... the goals and risk preferences of executives with limited equity stakes are likely to be different from those of shareholders..."(p. 326). Again, they are referring to economic risks when they develop their arguments.

An important question is whether the agency theory can apply in a different context, i.e., when firms are not motivated primarily by financial considerations when deciding on foreign ownership mode choice. It is well known that Asian firms (documented in Section 2) inject non-economic factors in the strategic corporate decision making process. A well-established body of theoretical and empirical literature on the decision making strategies of Asian firms provides clues that the (financial incentives based) agency

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theory does not work very well in an Asian context (for example, Gedajlovic & Shapiro, 2002; Lee & O'Neill, 2003; Tian & Lau, 2001). What happens to the ownership structure/executive compensation/corporate governance linkages when firms operate in an environment where risks include both economic and non-economic (network-based) relationship risks? Addressing this question becomes important from an academic perspective because it provides a better understanding of what motivates ownership choices for firms from the greater China region. Practitioners will also benefit from this research since they will have a better understanding of the factors that motive ownership choices of their potential partners in the greater China region. For instance, managers thinking of entering into joint ventures or strategic partnerships in these countries may want to consider local partner inclinations toward shared ownership because of non-agency theoretic considerations.

In this paper, we provide empirical evidence that a sample of Taiwanese firms investing in the greater China region over the 2001–2009 period consider non-economic factors over economic ones when deciding on ownership mode choice, offering an alternative explanation of major factors influencing the foreign ownership mode choice to the agency theory-based model (Musteen et al., 2009). The paper is organized as follows. In Section 2, we motivate our paper by presenting a brief theoretical and empirical literature review on the importance of non-economic factors in an Asian context that affects corporate decision making. This is followed by a brief description of the relevant literature associated with the determinants of foreign ownership mode choice. Next, sample details and characteristics are followed by a presentation of logit regression results. Findings are discussed in the penultimate section, followed by concluding comments and policy implications in Section 6.

## 2. Importance of non-economic factors in corporate strategic choices in an Asian context

The literature is replete with many examples of non-economic factors that influence a variety of strategic choices made by Asian firms. Most of them are related to the importance of network-based relationship in Asian societies. Oftentimes, these non-economic factors play a more important role than economic factors. Most notable example is the importance of guanxi[2] in the context of decision making. Park and Luo (2001) suggest that guanxi critically influences firm performance in China. Guanxi is also widely practiced by firms originating from other Chinese dominated Asian countries that include Taiwan, Hong Kong, and Singapore (see, for example, Ai, 2006; Chung, 2006; Hsu & Saxenian, 2000; Huang, Baek, & Min, 2010; Liou, 2009). Concepts deeply embodied in guanxi are the concepts of mianzi (face) and renqing. It is important for firms to maintain mianzi (an intangible form of social currency) to foster/enhance their guanxi business networks. Renqing is another form of social capital that obligates firms to reciprocate in guanxi networks, with significant social and monetary costs to the firm. The elements of mianzi and renqing make the concept of guanxi unique compared with the Western concept of social capital. In the current context of Taiwanese firms, firms opting for full ownership can expect to incur current and future social/monetary transaction costs of offending a guanxi partner expecting reciprocity since full ownership implies potential partners are shut out of the deal. As Ai (2006) states, [guanxi] business culture "... is ... long term oriented with more concern for benefit of members of the entire network..." (p. 116). Empirically, there have been strong links between guanxi based variables and a firm's accounting and market performance (Luo, 1997). Park and Luo (2001) show that guanxi is related to sales growth and not to profit growth. In the current context, this is important because agency theory relies on monetary incentives to motive managers. Hence, Asian firms will fail to motivate managers on the basis of profit growth if they (managers) believe that guanxi connections are more important.

Another example of non-economic factors for Asian firms is related to the role of insider (or family controlled) and institutionally dominated boards (as is typical for Asian firms) on corporate decision making. Unlike in the US, insider and institutional owners, who are dominated by politically connected members, may prefer strategies that decrease network-based relationship risks, even if it implies the assumption of higher levels of economic risk. For instance, Gedajlovic and Shapiro (2002) document the co-existence of agency effects (caused by economic incentives) and redistribution effects (caused by Japanese social context) when investigating the relationship between ownership concentration and firm performance for Japanese firms. On the one hand, they document evidence of a positive link between ownership concentration (insider dominated boards) and subsequent financial performance for Japanese firms (agency effects). On the other hand, for poorly performing Japanese firms, they find a significant negative relationship between ownership concentration and financial performance. As the Japanese firms engage in the practice of redistribution to promote "...inter-corporate goals of risk reduction and mutual assistance..." (p. 567) to members of the Keiretsu,[3] they find poorly performing Japanese firms with high ownership concentration benefit from the transfer of financial resources from profitable firms (redistribution effects). However, they find that for the entire sample of Japanese firms, the redistribution effects are stronger than the agency effects, indicating that the Japanese 'social context' (which emphasizes network-based relationships) matters. Similarly, Lee and O'Neill (2003) explicitly show that relationship-oriented forces dominate market forces when explaining observed relationships between ownership structure and R&D investments in Japan. Finally, Kim (2005) finds evidence that South Korean firms lose financial value if their boards have dense networks, while external network connections of the board enhance firm value. Chen (2001) finds that, unlike Western firms, Chinese and Taiwanese firms tend to place long-term family interests (non-economic factors) ahead of shareholder interests (economic factors) and emphasize the maintenance of long term family prestige over short term profits and preservation/enhancement of shareholder value.

In conclusion, the importance of such non-economic factors in Asian corporate decision-making has led many researchers to conclude that the stewardship theory, where managers make decisions based on their role as 'stewards' for other principals (for more on stewardship theory, see Fox & Hamilton, 1994; Lane, Cannella, & Lubatkin, 1998), is more relevant/useful than the agency theory in explaining various corporate strategic decisions by Asian firms (Lee & O'Neill, 2003; Peng, Zhang, & Li, 2007; Tian & Lau, 2001).[4] In addition, many corporate decision makers (shareholders) in Asian firms have limited ability to achieve economic diversification domestically. It is well known that institutional investors

[2] *Guanxi* refers to "... the concept of drawing on a web of connections to secure favors in personal and organizational relations..." (Park & Luo, 2001,p. 455). *Guanxi* can also be viewed as social capital or social networking.

[3] Provision of "mutual assistance" is also consistent with the *guanxi* business model prescriptions.

[4] Here, we argue that stewardship theory can provide *one* explanation for the importance of non economic factors in influencing foreign ownership choice behavior of Asian firms investing in the greater China region. Other researchers (cited earlier) have confirmed the validity of stewardship theory in an Asian context. For example, Lin (2005), Tian and Lau (2001), and Peng et al. (2007) provide strong evidence affirming the validity of stewardship theory in Asian countries. We are not suggesting that support against the validity of agency theory for greater China countries is de facto support for the validity of stewardship theory or social context theory in this context.