



Corporate governance, product market competition and dynamic capital structure



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ABSTRACT

Although the importance of both product market competition on managerial slack and the impact of corporate governance on capital structure decisions have been widely discussed in many of the prior related studies, it appears that very little attention has been paid to the effect of market competition on the relationship that exists between corporate governance and capital structure dynamics. Based upon an examination of this relationship in the present study, we find that product market competition increases the incentives for firms with weak governance structures to maximize the wealth of shareholders, thereby increasing the adjustment speed toward target leverage. Furthermore, the difference in such adjustment speed between firms with weak and strong governance structures is found to be smaller among firms operating in the highly competitive industries.

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1. Introduction

In an article published in the *Wall Street Journal*, Michael Milken, the chairman of the Milken Institute, pointed out that “It doesn’t matter whether a company is big or small. Capital structure matters. It always has and always will”; he further noted that when making financing decisions, managers must also consider industry dynamics (WSJ, 2009). Such comments suggest that when analyzing the dynamics of capital structure, industrial competitiveness may well be a key determinant.

Despite widespread discussions on the impact of corporate governance on the financing decisions of firms,¹ as well as the impact of market competition on corporate governance,² little attention has been paid to the interactions between the two effects (corporate governance and industrial competitiveness) on the speed of adjustment toward optimal target leverage. In the present study, we examine the impact of the interactions between corporate governance quality and product market competition on the adjustment speed of the capital structure of a firm.

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¹ The effects of corporate governance structures on capital structure choices have been documented in numerous studies, including Garvey and Hanka (1999), Harvey, Lins, and Roper (2004), Morellec (2004), Wald and Long (2007), Jiraporn, Kim, Kim, and Kitsabunnarat (2012), Morellec, Nikolov, and Schürhoff (2012), and Chang et al. (2014).

² Many studies suggest that product market competition plays an important role in terms of incentives aimed at enhancing managerial effort; examples include Fama (1980), Hart (1983), Scharfstein (1988), Schmidt (1997), Winston (1998), Raith (2003, 2008) and Karuna (2007).

Economists often presume that market competition prompts firms to perform better by forcing them to reduce their managerial slack; however, despite its intuitive appeal, when attempting to formalize the notion that competition can mitigate managerial slack, the related theoretical literature generally reveals ambiguous effects.³ Thus, market competition may encourage firms with weaker governance structures to create stronger (weaker) incentives for maximizing shareholder wealth, thereby resulting in an increase (reduction) in their adjustment speed toward the optimal capital structure. Such an increase (reduction) would ultimately reduce (widen) the gap in the adjustment speed between those firms with weaker and stronger governance structures. Thus, the way in which corporate governance quality and product market competition will affect the speed of capital adjustment remains an empirical question.

We use a reduced-form dynamic partial adjustment model, where corporate governance quality is represented by the G-index (Gompers, Ishii, & Metrick, 2003), which reflects the strength of shareholder rights. The extent of product market competition is also gauged in the present study by the Herfindahl–Hirschman index (HHI) based upon the four-digit ‘standard industry classification’ (SIC) codes.

Our empirical results reveal that competition provides greater incentives for firms with weak governance structures to reduce their managerial slack and maximize their shareholder wealth, leading to an increase in the speed of adjustment toward their target leverage; this increase further reduces the difference in the adjustment speeds of those firms with weak vis-à-vis strong governance structures. As a check for the robustness of our results, we re-examine them using an alternative proxy for corporate governance quality, the ‘E-index’ (Bebchuk, Cohen, & Ferrell, 2009), with the results remaining similar to those based on the G-index. Our results are also found to be robust across various alternative competition specifications.

Although the HHI based upon four-digit SIC codes is the main measure of competition used in the present study, similar results are obtained if the HHI is based upon two- or three-digit SIC codes, or indeed, the 48 industry classification scheme of Fama and French (1997). We also obtain similar results if we use either the industry net profit margin (the Lerner index) or the number of firms as the competition measure. Finally, our empirical results remain unaffected by the use of alternative definitions of the leverage ratio, the elimination of zero-debt boundary firms or consideration of asymmetric adjustment behavior.

To the best of our knowledge, no theoretical or empirical evidence has yet been presented on the effects of product market competition on the relationship between corporate governance quality and capital structure adjustment speed; thus, we aim to fill this gap in the present study. We also suggest that our results have important policy implications for firms in the less-competitive industries, since strengthening corporate governance regulations will provide particular benefits for such firms. Finally, we argue that the effects of corporate governance regulations can be further strengthened by taking appropriate measures, such as industry deregulation and the enactment of anti-trust laws, aimed at effectively increasing industrial competitiveness.

The remainder of this paper is organized as follows. A summary of the extant theoretical literature is provided in Section 2, along with the development of our testable hypotheses. An introduction to the dynamic partial adjustment capital structure model is subsequently provided in Section 3, followed in Section 4 by a description of the data, and the presentation of our empirical analyses in Section 5. Finally, the conclusions drawn from this study are presented in Section 6.

2. Literature review and hypothesis development

Economists often argue that managerial slack is a problem primarily concerning firms in the non-competitive industries, since the managers of firms in the more competitive industries have very strong incentives to reduce slack and maximize their profits; otherwise their firms are likely to go out of business.⁴ However, as noted by Holmström and Tirole (1989), “apparently, the simple idea that product market competition reduces slack is not as easy to formalize as one might think”. Support for the managerial incentives argument was provided by Machlup (1967), who noted that if firms were to operate in a perfectly competitive market, then their managers would have no opportunity to relax and shirk their responsibilities, essentially because those firms that fail to minimize their costs will ultimately be driven out of the market. Nevertheless, despite the intuitive appeal of this argument, subsequent studies have generally found quite ambiguous effects when attempting to formalize the idea that competition can help to mitigate managerial slack.

Hart (1983), for example, argued that competition merely reduces managerial slack, since the assumption in his model is that managers are more concerned with whether they will attain a given profit target level to maintain a given subsistence level of income; that is, managers will only put in sufficient effort to meet a fixed profit target, working efficiently when the profit level of the firm is below its target profit level, but slacking off when the profit exceeds the target level. In a competitive product market, firms will experience a reduction in their profit margin as a result of an increase in aggregate supply; their managers will then attempt to reduce any managerial slack and work harder to attain their target profit level.

The Hart (1983) argument, is, however sensitive to assumptions on managerial preferences. As pointed out by Scharfstein (1988), the main finding in Hart (1983) may well be reversed when the marginal utility of managers is positively related to their income; that is, the Scharfstein argument suggests that competition actually leads to an increase in managerial slack. In the Hart (1983) model, the manager is infinitely risk averse; thus, income above a given subsistence level has no value, whilst income below that level is catastrophic. Clearly, therefore, the overall effect of product market competition on managerial slack remains somewhat ambiguous.

³ Examples include Hart (1983), Scharfstein (1988), Schmidt (1997) and Raith (2003).

⁴ As noted by Scherer, “Over the long pull, there is one simple criterion for the survival of a business enterprise: Profits must be non-negative. No matter how strongly managers prefer to pursue other objectives ... failure to satisfy this criterion means ultimately that a firm will disappear from the economic scene” (Scherer, 1980: 38).

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