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Corporate governance and manager turnover: An unusual social experiment

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Abstract

This paper examines empirically the quality of the governance mechanisms of Chinese state-owned enterprises from 1994–1999, a period marked by substantial changes in policies affecting the governance structure of these firms. It shows that the restructuring of these enterprises according to corporate law improved the effectiveness of their governance system. Specifically, restructuring strengthened the links between manager turnover and firm performance. The results indicate that firm performance was significantly and negatively related to manager demotion for incorporated state-owned enterprises, while this relationship was insignificant for unincorporated enterprises. They also indicate that manager turnover was a viable incentive mechanism for improving future enterprise performance.

JEL classification: G30; N25; P31
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1. Introduction

The objective of a firm's governance system is to bring into conformity the interests of its managers with those of its other stakeholders in order to reduce the agency costs associated with the separation of ownership and control. Governance mechanisms strive to protect the interests of all stakeholders in the firm. The effectiveness of a firm's governance system is enhanced by such internal mechanisms as a board of directors coordinating shareholder actions in monitoring and policing managers' behavior, shareholder voting rights, a controlling bank monitoring manager behavior, and incentive contracts such as executive stock ownership to align manager interests with those of shareholders. It is also enhanced by external institutions such as a well-functioning capital market enabling the transfer of corporate control, a viable legal and regulatory system and a competitive managerial labor and output market. It is usually difficult to identify the relative effectiveness of different governance mechanisms since individual mechanisms tend to substitute for, or complement, one another. [1] Nevertheless, one can assess the effectiveness of a governance system by looking at overall outcomes.

An important outcome of the overall quality of a firm's governance system is manager turnover. If the governance system improves the stakeholders' abilities to monitor and control management, then this should, on average, result in the replacement of poorly performing managers with managers whose actions lead to better firm performance. Furthermore, manager turnover, and specifically the threat of dismissal may itself be an incentive scheme encouraging managers to pursue more efficient firm decisions. Thus, the relationship between manager turnover and firm performance is a good way of assessing the viability of a firm's governance system (see Kaplan, 1994a,b).

The evidence on the relationship between manager turnover and firm performance for firms in developed economies generally indicates that manager turnover is inversely related to firm performance (see, e.g. Kaplan, 1994a,b, 1997; Denis et al., 1997; Parrino, 1997; Kang and Shivdasani, 1995; Abe, 1997). There has also been increasing interest in recent years in the effectiveness of firm governance systems in emerging markets spurred partially by such events as the Asian financial crisis, the growing interest of institutional investors in emerging market securities, and privatization initiatives in emerging markets (see, e.g., Claessens et al., 1999; Lins, 2000; Khanna and Palepu, 1999). Gibson (2003) is the only study, however, that examines empirically the link between manager turnover and firm performance for emerging market firms. He finds that there are significant links between manager turnover and firm performance for over 1200 firms in eight emerging markets; his study does not include China, which is the focus of the present study.

The present paper contributes to the existing literature in several important ways. First, it examines the effectiveness of the governance system of a sample of firms con-

[1] For example, La Porta et al. (1998) show that concentrated firm ownership is more prevalent in countries with legal systems that provide poor protection to investor rights.