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Controlling ownership and firm performance in Taiwan: The role of external competition and internal governance ☆

Anlin Chen [a], Lanfeng Kao [b,*], Cheng-Shou Lu [c]

[a] 70 Lien Hai RD, Department of Business Management, National Sun Yat-sen University, Kaohsiung 80424, Taiwan
[b] 700 University RD Department of Finance, National University of Kaohsiung, Kaohsiung 81148, Taiwan
[c] 415 Chien Kung RD, Department of Wealth and Taxation Management, National Kaohsiung University of Applied Sciences, Kaohsiung 80778, Taiwan

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ABSTRACT

This study examines the relationship between controlling ownership and firm performance in Taiwan. We focus on whether external competition and internal governance alleviate the adverse impact of controlling ownership on firm performance and whether external governance dominates internal governance. We find that the relationship between controlling ownership and firm performance is inverted U-shaped. Firm performance increases with controlling ownership at a low ownership level but decreases with controlling ownership at a high ownership level. The negative effect of controlling ownership on firm performance at a high level of controlling ownership exists when external competition or internal governance is weak but disappears when external competition or internal governance is strong. Moreover, external competition is more effective and subsumes internal governance in mitigating the negative effect of controlling ownership on firm performance.

1. Introduction

Corporate governance consists of external and internal governance. Product market competition is considered as an effective external governance factor in monitoring management and reducing agency conflicts. This paper examines how external product market competition and internal governance

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* Corresponding author. Tel.: +886 7 5919502; fax: +886 7 5919329.
E-mail addresses: anlin@mail.nsysu.edu.tw (A. Chen), lanfeng@nuk.edu.tw (L. Kao), cslu@cc.kuas.edu.tw (C.-S. Lu).

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influence the relationship between top management ownership and firm performance in a weak investor protection economy from an agency conflict perspective.

The relationship between top management ownership and firm performance is controversial. The convergence of interest hypothesis indicates that as management ownership rises, managers are more likely to focus on value-maximization activities. Jensen and Meckling (1976) and Jensen (1993) argue that firm value increases with managerial ownership. Jensen (1993) and Chen et al. (2007) find evidence of a positive relationship between firm value and management ownership.

Contrary to the convergence of interest hypothesis, the entrenchment hypothesis implies that managers pursue their own interests to expropriate shareholders. Jensen and Ruback (1983) propose the entrenchment hypothesis, indicating that greater management ownership increases the possibility of managers' pursuing their own interests. Israel (1992) shows that firm value decreases when insider ownership is sufficiently high to expropriate minority shareholders. Bozec and Laurin (2008) also find that firm value decreases when controlling families have incentives and opportunities to expropriate minority shareholders. The entrenchment hypothesis implies a negative relationship between management ownership and firm performance at a high management ownership level.

Morck et al. (1988) combine the convergence of interest hypothesis and entrenchment hypothesis, arguing that the relationship between management ownership and firm value (measured by Tobin's Q) should be non-linear. Kim and Lu (2011) use quadratic regression specifications and report an inverted U-shaped relationship between managerial ownership and firm performance using U.S. data.

Internal and external governance can improve firm performance. For internal corporate governance mechanisms, previous studies have typically focused on the structure of the board of directors, such as CEO duality, board size, and board independence. When a CEO also serves as the chairperson of the board (COB), known as CEO duality, the management is not appropriately monitored, leading to more severe agency conflicts. Chen et al. (2005) and Tang et al. (2013) show that stockholder-manager agency conflicts are alleviated when CEO and COB positions are filled separately. Yermack (1996) indicates that a smaller board of directors is more effective, leading to a negative relationship between board size and firm value. Klein (2002) and Xie et al. (2003) argue that board independence improves corporate governance.

Stigler (1958) argues that intense competition can push inefficient firms out of the market. Schmidt (1997) indicates that intense competition raises the default and liquidation risks of firms, leading to reduced managerial agency conflicts. Shleifer and Vishny (1997) show that competition prohibits manager investment in negative NPV projects to reduce the agency costs of free cash flow. Bertrand and Mullainathan (2003) also demonstrate that competition eliminates the “quiet life” to reduce costs. Allen and Gale (2000) document product market competition as either a monitoring mechanism or a corporate governance mechanism to reduce agency conflicts.

In this paper, we examine the relationship between controlling ownership and firm performance and whether product market competition serves as an effective external governance mechanism in Taiwan. We examine the Taiwan market primarily because Taiwan is an emerging civil law country with concentration of ownership and with weak takeover threats. La Porta et al. (2000) document that civil law countries do not provide strong investor protection. Choy et al. (2011) characterize Taiwan as a country with high investor expropriation risk. Taiwanese firms are also likely affiliated with pyramidal or cross-holding structures with controlling families or groups, resulting in a highly concentrated ownership structure. Claessens et al. (2000) find that in East Asian countries including Taiwan, ownership is highly concentrated, deterring takeover threats.

Previous studies have shown that the inverted U-shaped relationship between management ownership and firm performance exists and that takeover threats play an important role in governance. It is worth examining if competition improves governance in a country such as Taiwan where takeover is not popular. This paper contributes to the literature by filling this gap. We examine whether external competition or internal governance mechanisms reduce the negative impacts of management ownership on firm performance at high levels of management ownership. How the internal governance or external competition alleviates the entrenchment effect in Taiwan is the key issue of this paper.

Our results are summarized as follows: We find that the relationship between controlling shareholder ownership and Tobin's Q in Taiwan is inverted U-shaped, which only exists when firms have weak external competition or weak internal governance. With strong external competition or strong internal governance, firm performance is positively related to controlling ownership. Strong external competition and/or internal governance can reduce the negative effect of controlling ownership on firm performance