CHAPTER 2
LITERATURE REVIEW

In this chapter, I will briefly review the literature on the inefficiency of state-owned shares, the relationship between ownership structure and firm performance in China’s listed companies, and top management turnover in China’s listed companies.

2.1. Inefficiency of state-owned shares

Property rights theory postulates that ownership structure should not matter if complete contracts can be written and enforced (Coase (1960), Williamson (1985), and Grossman and Hart (1986)). In the presence of incomplete contracts, the different objectives of the owners result in different managerial roles and thus have different effects on firm performance. Government stakes are generally argued to be less efficient than private stakes because of various reasons discussed below although the empirical findings are mixed (see the literature review by Megginson and Netter (2001) for market economies and Djanakov and Murrell (2002) for transitional economies). There are two perspectives on the reasons behind the poor incentives of government shareholders: political and managerial perspectives.

Political perspective

The political perspective concerns the temptation for political interference to divert managerial objectives away from profit maximization and towards such objectives as employment maximization. Williamson (1985) argues that state ownership could be preferable for a social welfare maximizing government because the government could impose socially desirable objectives. However, social welfare
maximization is usually at the expense of shareholders’ interests. In addition, governments do not always keep social welfare as a priority and thus the advantage of state ownership would disappear (Sappington and Stiglitz (1987)). The interests of individual politicians would also distort the role of governments even if they were social welfare maximizers. Shleifer and Vishny (1994) argue that individual politicians have their own goals, such as maximizing their political base. And, thus, politicians may deliberately transfer resources of firms to their political supporters through the control rights of state-owned shares. The interference of government and individual politicians could also lead to distortion of managerial investments decision and result in suboptimal investment by managers (Laffont and Tirole (1993)). All of these factors would normally be at the expense of corporate profitability (Boycko, Shleifer, and Vishny (1996)).

Managerial perspective

The managerial perspective also advocates private stakes but it focuses on different degrees of agency problems for different shareholders. State-share holders have less incentive to monitor top management than private shareholders, although the agency problem is common for every company whose owners cannot operate the firm themselves and have to delegate control to non-owner managers.²

There is voluminous literature about the principal-agent relationship (see Sappington (1991) for a review). The principal has resources but it is too complicated, too costly, or impossible to manage its resources him or herself. Thus the principal must hire an agent, who usually has no claims to the principal’s resources but has special information and knowledge, to manage its resources.

² Stiglitz (1994) argues that “(P)incipal-agent problems arise, but the nature of those principal-agent problems may differ little depending on whether ownership is public [state] or private”. I think he ignores the “absence of principal” problem for state-share holders.
Because of the information asymmetry\textsuperscript{3} and the self-interest of the agent,\textsuperscript{4} the interests of the principal and the agent will not be consistent. The agency theory concerns with how to align the interest of the agent with the principal. Starting from the seminal Jensen and Meckling (1976), the agency theory has been incorporated into the theory of firm to explain the managerial behaviour and ownership structure in modern corporations. Usually an agency relationship is defined as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. For the modern corporations the shareholders or residual risk bearers are the principals. They own all the resources in the corporation and bear all the residual risks. If the shareholders are diffused,\textsuperscript{5} as found by Berle and Means (1932), it is impossible for them to manage their resources directly. They must delegate the decision management rights to an agent, hence the phenomenon of separation of decision control and decision management emerges.

According to Fama and Jensen (1983), the decision process has four steps: initiation, ratification, implementation and monitoring. The principals (the shareholders) delegate the decision management rights (initiation and implementation) to the agent (CEO or top management) and retain decision control rights (ratification and monitoring). The separation of decision management and decision control (or separation of ownership and control) will cause serious agency problems (costs) if there is no efficient approach to control them.\textsuperscript{6}

\textsuperscript{3} Such as the agent’s exerted effort cannot be observed and the performance of the agent cannot be verified.
\textsuperscript{4} The agent will maximize its own wealth rather than that of the principal.
\textsuperscript{5} If controlling shareholders exists, they will manage the firm directly and the agency problem is not important. Another problem is the expropriation of minority shareholders by the controlling shareholders, just like that found in most Asian corporations by Claessens \textit{et al.} (2002) and Faccio, Lang and Young (2001).
\textsuperscript{6} Please refer to Fama and Jensen (1983) for the approach to controlling the implied agency problems.
According to the classical agency theory, each type of shareholder in China’s listed companies faces different degrees of principal-agent problems. The most serious ones are with the state-share holders. The reason is that it is very difficult or impossible to identify who the principal or residual risk bearer is. In theory, the whole population owns the shares. But there is no principal for the state-owned shares because there is no way for the whole population to act as a principal. This “absence of principal” problem, which causes the inefficiency of government shareholding, is widely discussed in China.

2.2. Ownership structure and firm performance in China

State shareholdings are detrimental to firm profitability based on both political perspective and managerial perspective. Hence, a negative correlation between state shareholdings and firm performance is expected in China’s listed companies. Some studies have examined the relationship but the results are still inconclusive. Prior literature finds that there are three types of relationship between state shareholdings and firm performance: weakly negative relationship, U-shaped relationship, and inverted U-shaped relationship. All the existing studies do not distinguish the type of state-share holders and thus their results should be interpreted with caution.

1. Weakly negative correlation. Xu and Wang (1999) investigate whether ownership structure significantly affects the performance of companies listed in both Shanghai and Shenzhen stock exchanges (SHSE and SZSE, hereafter) from 1993 to 1995. They find that the firm’s profitability “is either negatively correlated or uncorrelated with the fractions of state shares”. Qi, Wu, and Zhang (2000) re-examine the issue using the listed companies in SHSE from 1991 to 1996 and find
that firm performance is negatively related to the proportion of shares owned by the state. More recently, Sun and Tong (2003) evaluate the performance changes of 634 SOEs listed in SHSE and SZSE from year 1994 to 1998 and find that state ownership has negative impacts on firm performance. However, the negative relationship found in Sun and Tong (2003) is not significant even at the level of 0.1.

2. *U-shaped relationship.* On the other hand, Tian (2001) shows that the state shareholding of China’s listed companies is not entirely inefficient. By investigating 826 corporations listed in SHSE and SZSE, Tian (2001) finds that corporate value decreases with an increased size of state shareholding when the state is a small shareholder; when the state equity holding is sufficiently large, corporate value increases with increased state shareholding. This U-shaped relationship between state shareholding and corporate value is interpreted by the aggregated impacts of the grabbing hand (detrimental role) and helping hand (supportive role) of the state shareholder.

3. *Inverted U-shaped relationship.* Some other researchers argue that a certain level of state ownership seems optimal in China’s listed companies. Using a sample of companies listed in SHSE and SZSE from year 1994 to 1997, Sun, Tong, and Tong (2002) evaluate the impact of state ownership on firm performance together with other factors such as annual sales revenue (firm size), total debt ratio (leverage), firm location (coastal versus inland), presence of foreign investors (whether shareholding structure includes B-shares), and the impact of regulatory industries (e.g., utilities). Their results show that state ownership has a positive and significant impact on firm performance. Yet, they find that the positive relationship is nonlinear with an inverted U-shape.
2.3. Top management turnover in China

China is a country that features weak legal protection for investors and less efficient governance system. However, a significantly negative relationship between firm performance and top management turnover has been found in China’s listed companies. Firth, Fung, and Rui (2002) examine the determinants of chairperson turnover from year 1998 to 2000 in China’s listed companies. They find that performance based on accounting data is a key determinant of forced chairperson turnover. They also report evidence that board control by non-executive directors is an important factor in replacement decisions. Finally, they show that ownership structure, a dummy for state-owned shares, does not affect the probability of chairperson turnover. However, they do not investigate the effect of ownership structure on the sensitivity of chairperson turnover to firm performance, i.e., an interaction term between ownership structure dummy and performance measure. More importantly, they do not examine the effect of the type of state-share holders on CEO turnover.