The Impact of Agency Problems on Corporate Performance in China

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Abstract. This paper delves into the intricate dynamics of the horizontal agency problem within the realm of corporate governance in China, scrutinizing the inherent conflict of interest between controlling and minority shareholders amidst a backdrop of concentrated ownership. Its core objective is to comprehensively grasp the repercussions of this agency dilemma on firm value and corporate performance. Central to this investigation is the identification and analysis of institutional features that fuel the agency predicament, notably the pre-existing split-share structure and the prevalent establishment of pyramid ownership arrangements. In response to these challenges, this study advocates for two primary approaches to mitigate the agency conundrum: an informal approach driven by cultural factors, particularly rooted in Confucian ethics, and a formal strategy entailing robust legal safeguards and regulatory frameworks. The potential efficacy of these proposed measures in ameliorating conflicts of interest, curbing unethical conduct, and fortifying the rights of minority stakeholders, all while reducing agency costs and enhancing corporate performance.

Keywords: Agency Cost, Firm Performance, Corporate Governance.

1. Introduction

There has long been much debate worldwide, including within China, concerning the correlation between ownership and management. Prior to delving into the potential agency problems it may entail, it prompts us to first examine the corporate governance framework prevalent in Chinese enterprises. The selection of China as a point of reference is justified by its current prominent global economic standing and its representativeness of other non-US countries that may share a similar corporate governance structure [1]. The distinctive characteristics of the Chinese corporate governance structure lie in its highly concentrated ownership, wherein one or more major shareholders wield significant power and financial incentives to effectively oversee and control the firm [2]. To be more precise, while the traditional 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, meaning that the traditional agency problem typically revolves around a hierarchical vertical association, such as that between shareholders and employed managers [3]. However, given that the proportion of shares owned by controlling shareholders is approximately more than 30%, this high level of concentration in the ownership system may lead to controlling shareholders prioritizing their private interests over those of the minority shareholders [4]. In this instance, given the prevalence of one or more controlling shareholders in most firms, the principal owner-manager agency problems observed in many developed countries is not the primary concern in China. This is due to the ability of controlling shareholders to effectively regulate managers’ behavior, thereby aligning their actions with the interests of the dominant shareholders. As a result, there also exists a risk of managerial conduct acting in the interest of large shareholders expropriating the wealth of minority owners, leading to an increase in agency costs [1]. Nevertheless, the core primary agency dilemma in China remains within the realm of interaction between controlling and minority shareholders, distinct from the vertical agency problem found in Western contexts. This paper attempts to discern how the horizontal agency problem affects corporate performance in China. Within China’s unique concentrated ownership system, it will first explore the causes of this agency challenge, along with its impact on corporate performance using various performance metrics. Additionally, viable solutions to mitigate agency problems will be proposed to optimize organizational outcomes.

2. Influencing Factors of the Horizontal Agency Problem

The causes of the horizontal agency problem principally stem from two institutional characteristics in most Chinese enterprises: the deficiency in liquidity arising from the pre-existing split-share structure and the insider nature of the controlling shareholders, together with the prevalence of the pyramid ownership structure. These factors also result in information asymmetries and the incentive misalignment between controlling and minority shareholders.

2.1. Poor Liquidity of the Shares

To start with, the previous split-share structure is an important source of the problem. Most Chinese listed companies have three principal categories of shareholders: the state, the legal persons and individual investors [5]. Notably, approximately two-thirds of the shares held by the state and legal entities are non-tradable. Thus, the Chinese and foreign private investors are left with only one-third of the total shares that are eligible for issuance and trading on the market [5]. Established in the 1990s, this special system, namely, the split equity (SE) structure, permits the simultaneous existence of NTS (non-tradable shares) and TS (tradable shares). While this structure aims to support state-owned enterprises (SOEs) in obtaining capital and preserve state authority over vital assets, it also keeps controlling shareholders out of the profit stream from rising stock prices and lessens their motivation to raise firm values [6]. In this case, dividends, which also need to be distributed to other investors, represent the only way through which controlling shareholders can lawfully partake in profits. Consequently, expropriation emerges as a tempting option [2]. More specifically, as a result of the SE structure, there seem to be substantial agency costs due to the conflict of interest between NTS owners and TS holders. From the perspectives of non-tradable shareholders, their interests have nothing to do with the market mechanism, whereas tradable shareholders' interests are aligned with the firm's share price. Therefore, non-tradable shareholders are largely encouraged by the SE structure to engage in activities to serve their own interests, mostly at the expense of private investors [6]. The supporting evidence can be provided through the examination of corporate performance pre- and post-implementation of the 2005 Split Equity (SE) reform, initiated by the China Securities Regulatory Commission (CSRC). This reform facilitated the conversion of most non-tradable shares into tradable ones, thereby shifting ownership from state and legal entities to private investors. Through the analysis of a sample comprising 1293 publicly listed non-financial firms in China from 2000 to 2008, the study reveals a 2.7% decline in noncash assets within the average corporate cash holdings after the SE reform [7]. This decline is further accompanied by a notable reduction in the average corporate savings rate. The result shows that the previous SE structure has indeed exacerbated the conflict of interest between controlling and minority shareholders, justified by a higher level of illiquidity of the shares [1]. However, despite the removal of the SE structure greatly enhancing the incentive for both minority and controlling shareholders to increase the firm value, shares held by controlling shareholders continue to face illiquidity. This dilemma arises from the challenge faced by controlling shareholders in selling their shares on the market without exerting a substantial influence on stock prices. Market perception views the selling of shares by controlling shareholders as indicative of their insider concern about the company's future, which will potentially lead to a decline in stock prices. Hence, the misalignment of interests between controlling and minority shareholders persists, resulting in notable agency costs, albeit mitigated following the SE reform.

This agency problem, arising from the conflict of interest between controlling and minority shareholders within a concentrated ownership framework has a significantly detrimental influence upon corporate performance, impacting factors such as 'competitiveness, efficiency and effectiveness' [8]. Transparency plays a pivotal role in mitigating information asymmetries and addressing incentive incompatibility between those two types of shareholders, thereby enhancing market efficiency, and ultimately leading to improved corporate performance. Empirical evidence from studies conducted by Green et al. suggests that the implementation of the SE reform has positively affected the transparency of reformed companies within highly concentrated ownership systems, underscoring the significance of resolving agency problem in China [6].

2.2. Pyramidal Ownership Structure

The agency problem between corporate insiders and individual outside investors is significantly influenced by the other institutional feature of pyramid ownership structures prevalent in many enterprises worldwide, including China. While many countries have enacted stricter laws and regulations to safeguard minority shareholders from potential expropriation, China's legal framework falls short of providing adequate protection [9]. Consequently, the persistent emergence of pyramidal structures in Chinese firms poses a growing threat to private investors, thereby adversely impacting overall firm value and performance. The conceptualization of a pyramid structure can be traced back to La Porta et al., who defined it as characterized by a combination of ‘an ultimate owner’ and ‘at least one publicly traded company between the firm and the ultimate owner’ [10]. More specifically, let us suppose that Firm A possesses 56% of the ownership stake in Firm B, while Firm B also holds 56% of shares in Firm C, then in this case, a pyramid structure is established with Firm A being the ultimate owner of Firm C, owning 31.36% of its shares, and Firm B being the ‘publicly traded intermediate company’ [10]. It can tell from this example that moving up the pyramid, although Firm A has ultimate control over Firm C, the cash flow rights have diminished to only 31.36%. The disparity between increased control rights and reduced cash flow rights within pyramid ownership structures creates an enhanced incentive for controlling shareholders to wield their controlling power in a manner that facilitates wealth expropriation. This can occur at the detriment of the financial interests of private investors, thereby creating augmented agency costs

3. Resolving the Agency Problem

The resolution of the horizontal agency problem in China is primarily approached through two distinct dimensions: the informal and private enforcement mechanisms driven by individual ethical considerations, and the formal and public enforcement approach that relies on the framework of legal protection.

3.1. Informal Ethical Approach

Regarding the solutions to mitigate the agency problem in China, cultural factors, such as the effects of Confucian ethics and social relationships, are unneglectable [11]. According to research conducted by Du, he comes to the strong conclusion that Confucianism does effectively mitigate agency conflicts between the controlling and minority shareholders [12]. This assertion is based on an analysis of 12,061 firm-year observations drawn from the Chinese stock market spanning the period from 2001 to 2011. The findings imply that Confucianism functions as an unofficial mechanism to lessen the expropriation of minority shareholders in Chinese listed companies. It does this by strongly influencing business ethics and, in turn, lowering the unethical behavior of dominant shareholders. The pragmatic guidelines established by Confucian ethics to regulate people's behavior and relationships are the reason why Confucianism can be a successful solution to China's horizontal agency problem. These guidelines encourage the respect of authority, unity, conservatism, joyfulness, compassion for others, command, and stability [13]. For example, the golden rule set by Confucius- ‘Do not do unto others what you would not have them do unto you’ can be readily employed to settle conflicts of interest between controlling and minority shareholders and largely prevent unethical behaviors such as minority shareholder expropriation. This is because, in accordance with Confucian theory, if the two kinds of shareholders refuse to work together, a balance of ‘benevolence-loyalty relationship’ will unavoidably destroyed, ultimately compromising the interests of both parties [12].

3.2. Formal Legal Approach

In addition to the informal ethical system, the formal legal system should also keep up to resolve this problem. Legal protection, encompassing regulatory frameworks and enforcement mechanisms, plays a pivotal role in mitigating such challenges. Weak investor protection will inevitably lead to hesitation from the minority shareholders' side to invest, which can result in poor liquidity of shares, affecting market efficiency and corporate performance. However, strong investor protection can stimulate investment and encourage corporate innovation at the same time [1].

The importance of legal protection is effectively illustrated by La Porta et al. drawing upon data encompassing firms from 27 wealthy nations globally [14]. The empirical results highlight the close connection between an elevated standard for shareholder protection and greater valuation of companies. Moreover, the study indicates a positive relationship between higher investor protection levels and higher expropriation costs, which reduces the motivation of dominating shareholders to take actions that are damaging to minority stakeholder interests. The result highlights how essential legal frameworks are to creating a safe environment for investors, building confidence, and reducing agency conflicts in corporate settings. In China, as multiple rules and regulations have already been implemented to safeguard the rights of minority investors, it will examine how well they work to improve business performance and solve the agency problem. Furthermore, it will see if any more improvements should be made. With the fast growth in the numbers of individual minority investors, China has been steadily developing a comprehensive legislative framework following the securities market's founding in 1990. According to Fang et al., the completeness of the law is crucial because it is directly linked with the cost of Chinese listed companies as well as the rights of minority shareholders [15]. By adopting a theoretical analysis, Fang et al. shows that improving legal frameworks correlates positively with increased litigations and a higher number of inverstor's claims, while inversely related with the duration of legal proceedings [15]. As illustrated by Figure 1, this negative binomial regression model strongly affirms the beneficial impact of legal reforms on protecting minority investors. To be more specific, as a result of the ongoing effort to reform the legal system in China, the number of litigations and claims has considerably gone up thanks to the lower investors' litigation costs and improved court services, etc. Moreover, the judicial procedures are also greatly shortened due to the clarification of the legal rules. That is to say, the legal protection in China has evolved to overcome the major drawback of the incompleteness of the law and has also enhanced minority investor's confidence in protecting their rights, thus making the offenders less motivated to conduct expropriation behaviors. However, the effectiveness of the law enforcement is still debatable because although the public enforcement issued by the CSRC and the two domestic stock exchanges, namely the Shanghai Stock Exchange (SSE)and the Shenzhen Stock Exchange (SZSE), does seem to be constantly evolving and put in place, the private enforcement that based on market discipline and individual ability to issue litigations or claims, still has a long way to go [1].

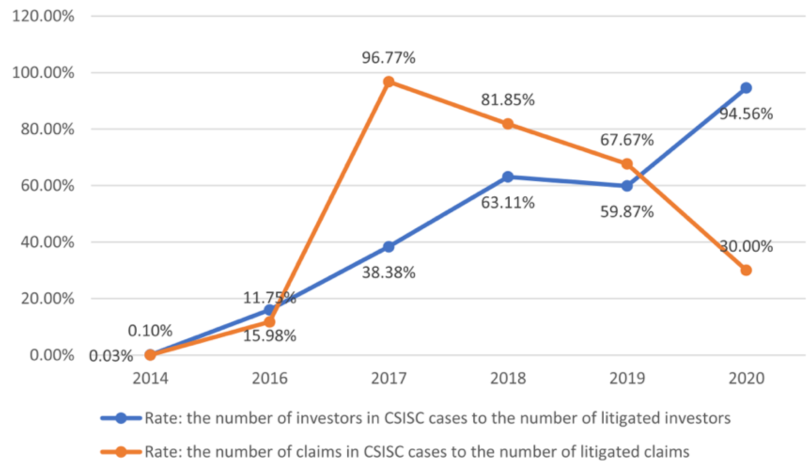

Figure 1. The number of investors and claims in CSISC cases to the litigated number [15]

4. Conclusion

In conclusion, different from the common vertical agency problem observed in most Western countries, the horizontal agency problem stemming from the conflict of interest between controlling and minority shareholders within China’s concentrated ownership system poses a significant impact on corporate performance. This paper analyses the relationship between agency problems and corporate performance when considering the concept of transparency and information asymmetries, market effectiveness and efficiency. Furthermore, the causes of the agency problem are largely identified as being the illiquidity of shares due to the previous implementation of the SE structure as well as the pyramidal ownership structure. Resolving this kind of agency problem requires both informal and formal approach: cultural factors, such as Confucian ethics, can act as moral constraints in mitigating conflicts between shareholders, while the legal reformation provides strong investor protection for minority shareholders, however the effectiveness of its law enforcement remains a concern. In moving forward, in order to reduce the agency costs and enhance corporate performance, the relative institutions and individuals should foster an environment that favors minority and individual shareholders’ right, market efficiency and corporate governance transparency.

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