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Government ownership and corporate governance: Evidence from the EU

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ABSTRACT

The ongoing global financial crisis has led to the largest increase in state intervention since the Great Depression. Direct government ownership in publicly-traded corporations has increased dramatically since 2008. How will this increase in public ownership affect the governance of these erstwhile private companies? We examine the impact of government ownership on corporate governance using a sample of firms from the European Union, a region that is relatively familiar with active government participation. Our main finding is that government ownership is associated with lower governance quality. We further show that while government intervention is negatively related to governance quality in civil law countries, it is positively related to governance quality in common law countries. Finally, we find that the preferential voting rights of golden shares are especially damaging to governance quality.

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1. Introduction

The debate over government involvement in private enterprises has been reopened because of the worldwide intervention by governments that followed the recent financial crisis. The last few years have brought a significant shift from free market capitalism towards state ownership and control in countries around the world, particularly in areas of corporate governance. In March 2009, the Obama administration used the threat of refusing bailout money to force out General Motors CEO Rick Wagoner and most of the firm's board members. The three top executives of Caisse d'Epargne, France's third-largest retail bank, resigned in October 2008 after the bank suffered a loss of €600 million from trading derivatives. President Nicolas Sarkozy and the French government urged the bank's executives to "take the consequences" of the huge losses and welcomed the resignations of the bank's leadership.[1] Against this backdrop, we examine the impact of government influence on corporate governance practices at firms with government ownership. It is possible that increasing levels of government ownership will lead to greater monitoring in particular, and improved governance in general, because of governments' monopoly on the use of coercive power. Governments wield bigger sticks and carrots than any potential private-sector partner. For example, state shareholders were ready to oust board members opposed to the appointment of the government's choice for the new chairman of Thales, a company partially owned by the French state, in May 2009.[2] On the other hand, it is not at all clear that government interests are aligned with shareholder interests. Governments are much more likely to use their influence to maximize employment, for example, even if the hiring of additional workers is not warranted based on a firm-level, cost-benefit analysis (Megginson, 2005). State owners could be reluctant to allow corporate governance improvements that would interfere with their non-profit-maximizing goals.

In this study, we draw on a sample of 373 companies from 14 European Union (EU) countries during the period 2003–2008 to test the impact of government ownership on corporate governance. We utilize RiskMetrics Corporate Governance Quotient (CGQ), which incorporates the most widely used corporate governance proxies. This measure is popular in studies with non-US samples because international corporate governance data are difficult to collect and because comparing non-standardized governance measures across countries can be problematic.[3] Since CGQ is a rating based on multiple corporate governance measures, we also examine specific subcomponents that have received significant

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[1] Sources: Wall Street Journal (March 30, 2009), Economist (November 29, 2008), and Bloomberg (October 20, 2008).

[2] Source: The Financial Times (May 19, 2009).

[3] For a sample of recent studies that compare corporate governance across countries using CGQ components, see Doidge et al. (2007), Aggarwal et al. (2009), Chhaochharia and Laeven (2009), Bruno and Claessens (2010), and Aggarwal et al. (2011).

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attention in the literature (e.g., Bruno and Claessens, 2010): board independence, the presence of board committees, board entrenchment, committee independence, board transparency, and CEO power. By considering these elements, we address the central question of the analysis: how do the corporate governance practices of firms with state ownership compare to those of firms not held by the state?

We measure state presence as the percentage of government ownership in our sample of publicly-traded corporations. Because the state frequently maintains partial ownership after privatizations, we use a pool of privatized firms as a starting point for the construction of our sample. Next, we examine the influence of legal origin on the relation between government ownership and corporate governance. Previous research (e.g., La Porta et al., 1998, 1999b) suggests that a country's legal and regulatory framework plays a significant role in capital market development, governance, and the behavior of the state. Finally, we investigate how the presence of additional voting rights through golden shares affects the government ownership-corporate governance relation. This latter part of the study examines whether the type (as opposed to the amount) of government ownership has an incremental effect on corporate governance quality.

Our first set of empirical results shows that government ownership is generally detrimental to good corporate governance, consistent with the state's interests not being completely in line with those of the firm. Isolating national government holdings from total government ownership, we find that the negative effect of state holdings is mostly due to national ownership. We also find some evidence that central governments have a particularly damaging impact on governance by decreasing the number of board committees and augmenting CEO power, implying that governments attempt to maintain control by concentrating power within a firm. Our second set of results confirms that the legal framework of common law (civil law) countries has a positive (negative) incremental impact on the relation between government ownership and corporate governance, with the state furthering the practices fostered by its legal system. Finally, we show that the use of golden shares has an incrementally negative effect on corporate governance. While government ownership is generally associated with weaker corporate governance, the government's ability to leverage up its voting power through golden shares is especially damaging.

Throughout the study, we are mindful of the possible influence of endogeneity on our empirical results. We address these potential concerns in several ways. First, we use lagged government ownership throughout the study. Second, the government ownership we collect is *retained* ownership in previously state-owned enterprises that are now owned in part by the private sector. After a government sells part of its holdings in a company, it often maintains a large ownership stake. As time passes, the state continues to decrease its holdings through subsequent tranche sales. Therefore, the residual government ownership level in such firms is not a result of active investment policies due to contemporaneous corporate governance quality, which precludes the reading of reverse causality in our results. Third, we use fixed effects in all of our models, and fourth, we use an instrumental variable approach to further control for the association between state ownership and corporate governance quality. All of these econometric methods reveal consistent empirical results.

The primary contribution of our study is to expand knowledge of the governance role played by state actors. Denis and McConnell (2003) identify this aspect of corporate governance as an especially underdeveloped area in the literature. Addressing this relative void is all the more important in the context of the 2008 global financial crisis and the concomitant rise of government ownership. Related regional or country-specific studies also argue that government ownership can have significant effects on firm policy. Price et al. (2011) characterize the government ownership and frequent bailouts prevalent in Mexico until the late-1990s as engendering an apathetic view towards corporate governance. In a study of Argentine banks, Berger et al. (2005) associate the governance fostered by state ownership with inefficiencies and poor performance. Fan et al. (2007) show that Chinese government-owned firms which retain politically-connected CEOs perform worse than those with unconnected CEOs. They also find that politically-connected CEOs are more likely to appoint other bureaucrats to the board of directors. These results suggest that government intervention in corporations is negatively related to corporate governance quality, an idea that Ferri (2009) discusses in the context of the Chinese banking sector.

The remainder of the paper is organized as follows. In Section 2, we discuss why government owners are of special interest to academics and practitioners. We describe our data and methodology in Section 3. In Section 4, we present and discuss our empirical results and perform robustness checks. We briefly conclude in Section 5.

2. Why are governments unique owners?

2.1. The state as a conflicted institutional owner

Besides its persistent role in the corporate world, there are many characteristics that make the state a unique owner worthy of study. Governments and institutional investors are similar in many ways because of their significant resources and power. However, governments and institutions can often have very different objectives, which can lead to disparate outcomes when it comes to their effect on corporate governance. Governments tend to have much deeper pockets than institutions, and in most developed economies, governments can leverage themselves almost infinitely, using implicit guarantees to secure debt financing for state-controlled firms (Borisova and Megginson, 2011). The relative ease with which these firms secure financing could discourage monitoring, allowing agency problems to develop. Additionally, governments have the ability to create regulations that can positively or negatively affect a company, even to the point of forcing it to shut down. Institutional owners arguably have an informational advantage over the average investor because of their superior research and analytical skills. Governments have a different informational advantage in their ability to demand any and all information about a firm through regulatory or legal means. Perhaps the biggest difference (and likely the most relevant to this study) between institutions and governments is that institutions' sole objective is to profit from their investments. The state might want profitable investments as well, but their motivation can also include the reduction of unemployment, increase in tax collection, and overall stability of the financial system. Government owners could work to prevent governance improvements that would curtail the realization of these alternative goals. In short, governments and institutions share some similarities, but governments have much greater access to resources than institutions and might own firms for reasons other than the maximization of wealth.

Because institutional investors are influential and prevalent in financial markets, there is a vast literature exploring how they affect corporate governance quality. For example, Gillan and Starks (2000) find that financial institutions are more successful in instituting shareholder proposals. When financial institutions face too much resistance, they just "vote with their feet" and sell out (Parrino et al., 2003), damaging companies' reputations. However, due to bureaucratic or social policies, government owners may be somewhat less mobile than these institutional investors and therefore more likely to maintain their stake and desire for governance

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