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Corporate governance and firm value: Evidence from Chinese state-controlled listed firms

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ABSTRACT

The association between corporate governance and firm value has been extensively studied in Chinese listed firms. Based on the characteristics of their ultimate shareholders, Chinese listed firms can be categorised as (1) central state-controlled, (2) local state-controlled or (3) non-state-controlled. Some scholars have described Chinese government policy as '*zhuada fangxiao*', thus suggesting that the corporate governance mechanisms (CGMs) of central state-controlled listed firms (SCLFs) are better than those of local state-controlled listed firms. Therefore, this paper specifically examines the influence of CGMs on the value of central SCLFs and local SCLFs. Analysis of 2006 firm-year observations from 2007 to 2009 suggests that the aggregate ownership of other large shareholders and the remuneration of top executives exhibit different effects on firm value in central and local SCLFs. The results also provide evidence that there is no endogenous effect of firm value on the ownership of the largest shareholder in central and local SCLFs.

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1. Introduction

1.1. Historical development

Since launching its open door policy in 1978, the Chinese government has continued to reform the corporate policies of state-owned enterprises (SOEs) and has improved connections between the state economy and the market economy. As SOEs are a substantial part of the national economy and of government revenue, the Chinese government has gradually privatized SOEs to raise funds for expansions and to increase efficiency. The history of this gradual transformation of Chinese SOEs is summarized in Table 1.

Most Chinese listed firms were established through the privatization of SOEs. To maintain their dominant position, equity in listed firms is divided into A-shares, B-shares, H-shares, state-owned shares, institutional shares, employee shares and other shares, but only A-, B- and H-shares can be freely traded. A- and B-shares are generally traded on two domestic stock exchanges whereas H-shares are traded on the Hong Kong Stock Exchange. Before the share reform[1] of 2005, state shares could not be traded on any stock exchange (i.e., they were non-tradable shares). Table 2 illustrates the percentage of state-owned shares from 2001 to 2007. The average percentage of state-owned shares between 2001 and 2005 (before the share reform) was approximately 46.5% of the total shares but the percentage of state-owned shares decreased to 26.9% in 2007.

1.2. Motivation of the study

Traditional SOEs were initially ideological organizations created as work units (*gongzuo danwei*) to serve social and political purposes rather than to meet economic objectives. The primary stakeholders of SOEs were public officials, government bureaucrats and top managers appointed to run the SOEs, who enjoyed the same privileges as state cadres (*guojia ganbu*). Secondary stakeholders were the SOEs' workers, who expected an 'iron rice bowl' (*tiefanwan*) with cradle-to-grave benefits (Hua et al., 2006).

State ownership is widely viewed as, and has been repeatedly demonstrated to be, inefficient (Boycko et al., 1995). Both the profit motives and the political motives of government officials have the potential to significantly distort objective policy (Trebilcock and Iacobucci, 2003). Recognizing these potential problems, the Chinese government has been gradually privatizing its SOEs, either through management buyouts or by going public (i.e., by listing them on the Chinese and Hong Kong stock markets).

1.2.1. Reform of state-owned enterprises (zhuada fangxiao policy)

The early economic reform that introduced the price system and profit incentives to SOEs did not significantly improve their performance. Consequently, President Jiang Zemin announced the *zhuada fangxiao* policy (grasp the large, release the small) at the Fifteenth Communist Party Congress in 1997. Under this policy, the central government retained ownership of SOEs that (1) produce defence goods and services, (2) are in industrial sectors targeted for economic development or (3) are insolvent, but employed millions of employees.[2] The central government decided that the state should withdraw from the competitive sectors of the national economy and only concentrate on strategic industries. The *zhuada fangxiao* strategy was therefore announced as the guiding principle for SOE reform, which after various experiments at local levels has been interpreted as privatizing all but the largest SOEs controlled by the central government or the central SOEs (Leng, 2009).

[1] Before the share reform, state-owned and legal person shares (normally including those shares held by the largest shareholders) were non-tradable on any stock exchange. The share reform involved a capital reorganization that converted non-tradable shares into tradable ones.

[2] Extracted from the report 'Five challenges that China must overcome to sustain economic growth', released by the Joint Economic Committee of the United States Congress in July 2006. Available from the website: http://www3.nccu.edu.tw/~hmlien/social%20insurance%20in%20china/paper/FIVE%20CHALLENGES%20THAT%20CHINA%20MUST%20OVERCOME.pdf, accessed 27 July 2012.