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How much control causes tunneling? Evidence from China

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ABSTRACT

We study the dynamic causal effects of the shareholding ratio of controlling shareholder on tunneling behavior in China. We use control-right-transfers as the event to conduct the study. We obtain 394 control-right-transfer samples in China corporate control market from 2001 to 2008. We use related party transactions amount to capture control shareholders' tunneling activities, and make the following findings. Firstly, tunneling behavior is significantly affected by the shareholding ratio of controlling shareholder. Secondly, the relationship between tunneling and shareholding ratio of controlling shareholder takes an N shape (incline-decline-incline). There are at least two turning points in the relationship. Furthermore, firms with shareholding ratios of controlling shareholder that range from 34.46% to 39.01% (8.99–18.04%) exhibit the most (least) severe tunneling. Firm size is significantly positively related to tunneling activities. In addition, the shareholding ratios of the board and the tunneling activities are significantly negatively correlated. These findings imply the shareholding ratio decision of controlling shareholder in control transfers lead to agency problems manifested in China in a particular form of tunneling.

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1. Introduction

Ever since the tunneling behavior of controlling shareholders was first identified, it has been studied extensively. Companies with concentrated ownership structures[1] typically have one controlling shareholder.[2] Controlling shareholders can access benefits by either creating or transferring a company's wealth. When creating wealth, controlling shareholders derive benefits from the general value enhancement that results from improved management, which is known as the alignment (incentive) effect. Conversely, when engaging in wealth transfers, controlling shareholders obtain private benefits by expropriating minority shareholder benefits, which is also known as the tunneling (entrenchment) effect (Shleifer and Vishny, 1986; Johnson et al., 2000). It is generally believed that ownership structure affects controlling shareholders' tunneling and alignment decisions and that in turn, tunneling behavior affects firm value.

Most of the research on this topic examines the relationship between ownership structure and firm value, with the assumption that ownership structure (particularly with respect to the difference between control rights and cash-flow rights) affects the controlling shareholders' tunneling behavior, which affects firm value. The general findings in this direction support the inverted U-shaped (or concave) relationship between ownership structure and firm value (Morck et al., 1988; Stulz, 1988; McConnell and Servaes, 1990). In addition, some research finds that a disparity between control rights and cash-flow rights triggers tunneling activity, which decreases firm value (Lins, 2003; Claessens et al., 2002).

Subsequent studies have investigated the relationship between tunneling and firm value and have arrived at results that are consistent with the conclusions discussed above. Tunneling activity and firm value are negatively correlated, and more severe tunneling activity leads to lower firm value (Jiang et al., 2010).

Thus far, no studies have examined the direct relationship between the shareholding ratio of controlling shareholder and tunneling. Although previous studies assume that certain ownership structures will trigger tunneling and eventually affect firm value, none of the previous research directly examines how the shareholding ratio of controlling shareholder affects tunneling. The theoretical models of Johnson et al. (2000) and LLSV (2002) imply that controlling shareholders' equity holdings affect their tunneling behavior, but there is no empirical evidence to support this theoretical conjecture.

In this paper, we aim to offer a comprehensive study of the causal effects of the shareholding ratio of controlling shareholder on tunneling behavior in China; our primary purpose was to study the direct relationship between the shareholding ratio of controlling shareholder and tunneling activity. We use control-rights-transfer events to study the research question in the China corporate control market from 2001 to 2008. Theoretically, we modify and extend the theoretical models of Johnson et al. (2000) and LLSV (2002). We explicitly study the direct relationship between the shareholding ratio of controlling shareholder and tunneling. We then offer empirical findings and analysis to verify our theoretical conjectures.

Our primary findings are as follows: (1) tunneling activities are likely to be a consequence of the controlled shareholding ratio, whereas the shareholding ratio of controlling shareholder is not significantly impacted by tunneling activities; (2) in addition to being a monotonic or quadratic function relation, the relationship between tunneling activities and the shareholding ratio of controlling shareholder is a cubic function relation, an "incline-decline-incline" trend (an N-shaped) relationship; and (3) firms with shareholding ratios of controlling shareholders in the 34.46–39.01% range have the most severe tunneling activities, whereas firms in the 8.99–18.04% range have the least tunneling activities.

We make five major contributions to the literature (Johnson et al., 2000; Bae et al., 2002; Bertrand et al., 2002; Baek et al., 2006; Urzúa I, 2009; Atanasov et al., 2010; Jiang et al., 2010; Siegel and Choudhury, 2012; Buchuk et al., 2014, and Piotroski and Zhang, 2014). First, we provide direct evidence of the relationship between the shareholding ratio of controlling shareholder and tunneling behavior. Second, we construct a theoretical model to depict the cubic function relation between the two variables. Third, we design a set of

[1] Over the past decade, studies have shown that corporate ownership structures are concentrated rather than dispersed in most countries, particularly those with weak investor protections (La Porta et al, 1998, 1999).

[2] The controlling shareholder is either the shareholder that controls the company and owns 50% or more equity or the shareholder that owns less than 50% equity but dominates the company's daily operations and decision-making and uses the company's property by virtue of his superior position.

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