



# Product market competition, ultimate controlling structure and related party transactions

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## ABSTRACT

Previous studies have shown that product market competition has an important effect on corporate strategies and internal governance mechanisms. Using a sample of China's listed firms from 2004 to 2009, we explore the relationship between product market competition and normal related party transactions and find a significant positive relationship. In addition, we investigate the substitutive effect of product market competition and the cash flow rights owned by ultimate controlling shareholders on the extent of normal related party transactions. In particular, our results suggest a positive relationship between the ultimate controlling shareholders' cash flow rights and normal related party transactions that is strongest in noncompetitive industries and weakens as product market competition increases.

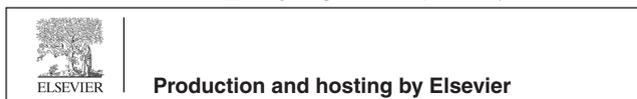
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## 1. Introduction

Product market competition plays a pivotal role in influencing corporate strategies and internal governance mechanisms. Shleifer and Vishny (1997) argue that “product market competition is probably the most

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powerful force towards economic efficiency in the world.” Competition increases the probability that firms with high costs will go bankrupt (Schmidt, 1997) and fear of bankruptcy is a strong incentive for managers to exert the effort required to remain competitive (Hart, 1983). Further analysis shows that product market competition is a substitute for internal governance that reduces agency costs (Karuna, 2010; Giroud and Mueller, 2011).

The role of related party transactions (*RPTs*) within business groups is widely discussed in the literature. Efficiency-enhancing theory suggests that imperfect emerging markets increase transaction costs that can be largely reduced through *RPTs* between the members of a business group (Khanna and Palepu, 1997, 2000). In contrast, agency theory argues that *RPTs* can be used in the expropriation of listed companies. In particular, business groups could use abnormal *RPTs* to tunnel resources from listed firms (Liu et al., 2008; Chang and Hong, 2000).

Following these studies, particularly the methodology of Jian and Wong (2010), we classify *RPTs* as normal or abnormal. Normal *RPTs* can decrease the transaction costs of listed firms, whereas abnormal *RPTs* can be used as a way of tunneling or propping business groups’ specific purposes. According to the efficiency-enhancing view, normal *RPTs* help firms to reduce transaction costs and increase value. This implies that product market competition leads to a greater need for normal *RPTs* to reduce transaction costs. Given that controlling shareholders with substantially more cash flow rights have strong incentives to maximize firm profits through normal *RPTs* (Shleifer and Vishny, 1986), we expect to observe a substitution effect between product market competition and controlling shareholders’ cash flow rights.

Our empirical evidence is consistent with these predictions. Using a sample of China’s A-share listed firms from 2004 to 2009, we show that product market competition has a significant positive effect on normal *RPTs*. That is, firms from more competitive industries tend to reduce transaction costs by increasing normal *RPTs*. We also find that product market competition and ultimate controlling shareholder’s cash flow rights have a substitutive effect on normal *RPTs*. Specifically, we note a positive relationship between ultimate controlling shareholders’ cash flow rights and normal *RPTs*. Moreover, this relationship is strongest in noncompetitive industries and weakens as product market competition increases.

Our study contributes to the literature in the following ways. First, it adds to the rapidly expanding work on the effects of product market competition. For example, Aghion et al. (2006) investigate the relationship between product market competition and vertical integration. Our results suggest that product market competition also affects firms’ transactions, i.e. firms from more competitive industries are more likely to have normal *RPTs* that reduce transaction costs. Second, our study has an important implication for research on ultimate controlling shareholders. Previous studies have mainly investigated the tunneling of ultimate controlling shareholders based on agency theory, ignoring the alignment of interests between controlling shareholders and other investors. Our results provide evidence that the cash flow rights of ultimate controlling shareholders have a positive effect on firms. Finally, we shed light on the relationship between external and internal corporate governance. Previous studies have shown that product market competition can either complement or substitute for some internal corporate governance mechanisms (Karuna, 2010; Giroud and Mueller, 2011). Our findings support the substitution effect by showing that the influence of ownership structure on the occurrence of normal *RPTs* is weakened by product market competitiveness.

The remainder of this paper is organized as follows. Section 2 develops the hypotheses and discusses the related empirical predictions. Section 3 discusses methodological and empirical issues. Section 4 presents our empirical results and Section 5 concludes the paper.

## 2. Literature review and hypothesis development

### 2.1. Product market competition and *RPTs*

Previous studies have shown that product market competition is pivotal in influencing firm profitability and corporate strategy. While earlier literature speculates that insufficient competition leads to managerial slack, Hart (1983) formalizes the idea that product market competition reduces managerial slack. In contrast, Raith (2003) argues that competition induces firm exit, which creates higher cost reduction incentives for the remaining firms. Following this, numerous studies have examined the economic consequences of competition

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