

Three essays on Corporate Governance, Managerial Incentives, and Government Expenditures

Chapter 1: “Institutional Investors Activism Revisited: Investment Targeting and Evidence of Control”

This paper examines the cross-sectional determinants of the concentration of institutional shareholdings in the US. We argue that the variation in large institutional holdings arises because of the different benefits and costs of monitoring. We identify agency related measures that can induce more monitoring by shareholders, and the cost related to large shareholding. Using data on institutional ownership from 1992 to 2001, we find that the firms where shareholder monitoring could be more valuable are indeed more likely to have a large institutional holding.

In the second part of the paper, we further show that large institutional holdings represent monitoring. We use the predicted probability of having large institutional investor as the measure of shareholder monitoring, to avoid biases that may be important if actual shareholding is endogenous. Measuring monitoring outcomes by variables such as the shape of equity incentives and investment efficiency, the results imply firms that are more likely to have large institution display outcomes corresponding to better monitoring. Together with the result that institutions choose to acquire large holdings of firms where their monitoring could be profitable, this study gives further support for institutional investors’ active role in corporate governance – they seek places to monitor and indeed provide monitoring.

Chapter 2: “The Role of Peer Performance in Managerial Compensation surrounding the 1996 Telecommunications Act” (with Shijun Cheng)

A major empirical prediction of agency theory concerns the use of relative performance evaluation (RPE) in incentive contracts. RPE helps filter a common industry or market effect by evaluating an individual firm’s performance relative to other firms facing the same effects. The literature suggests that product market competition enhances the usefulness of RPE, because in more competitive environments managers are more likely to face similar uncertainties, have more peers, and are less likely to affect other firms’ output. This paper empirically confirms this argument using a natural experimental setting – the deregulation of the U.S. telecommunications industry, which exogenously intensified competition in the industry.

There are two major limitations of the existing empirical studies on the relation between product market competition and RPE. First, they assume that industry structures and concentrations are exogenous to the determination of compensation contracts. Second, the concentration measures used in the studies may not fully reflect every dimension of

product market competition. In this study, we use the introduction of the US 1996 Telecommunications Act as our empirical setting to examine the dynamics of peer performance in managerial compensation. This setting helps overcome the empirical limitations. We adopt a difference-in-differences design using size- and performance-matched manufacturing firms as the benchmarks. The results indicate that, relative to the benchmark firms, telecommunications firms strengthened the (negative) tie between managerial compensation and peer performance after the Act. The effect is significant for peer stock returns, and in the same direction, though not significant, for peer accounting return on equity. The results suggest that relative performance evaluation became more valuable for telecommunication firms after the Act.

Chapter 3: “The Flypaper Effect: Evidence from the Tobacco Settlement Payment to States” (with Xin Li)

Tobacco settlements between the U.S. states and major tobacco manufacturers in the late 1990s commit tobacco companies to making annual payments to in perpetuity, with total payments over the first 25 years estimated at several hundred billion dollars. The magnitude and duration of the payments provide a unique natural experiment to study individual state spending responses to the windfall receipts. An empirical anomaly exists regarding the response of public spending to intergovernmental grants, and is often referred to as the “flypaper effect”. Grants are found to boost government spending more than an equivalent increase in private income, which is at odds with the theoretical prediction assuming fully fungible resources. Estimation bias due to the price effect or policy endogeneity is often criticized in the “flypaper effect” literature. Since the tobacco payments are not only unconditional non-earmarked lump-sum transfers to state governments, but also exogenous to policy variations, this study avoids potential estimation bias.

We adopt a first differencing approach and find strong evidence of the flypaper effect. State direct spending increases by 80 to 90 cents in response to a one dollar increase in settlement funds, and by about 2 cents for a similar increase in private income. States also tend to respond differently to the windfall. Their spending patterns reflect voter preferences that can be inferred from socio-economic characteristics. We find that states with a higher adult smoking prevalence rate, or with a large tobacco-manufacturing sector, exhibit a lower spending propensity. States that have partially or entirely securitized their settlement revenue tend to have larger spending responses due to the anticipation effect.