Guanxi and corporate governance:

Waging war on best practice

Mike W. Peng

Jindal Chair of Global Strategy

Jindal School of Management

University of Texas at Dallas

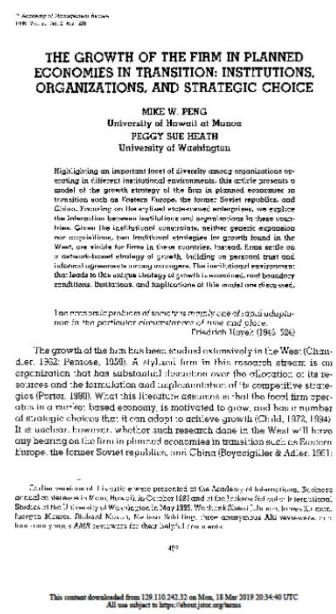
www.mikepeng.com

Social Networks of Chinese Entrepreneurs Workshop

Booth School of Business, University of Chicago, April 6, 2019

MY EARLIEST CHINA/CEE/ EE/*GUANXI* RESEARCH

- Peng and Heath (1996 AMR): The growth of the firm
- Inspired by Penrose (1959), P&H (1996) extends firm growth and strategy research to EE
- Identified a *network*-based strategy of growth
- Cited Burt, Nee, Walder ☺



THE GROWTH OF THE FIRM IN PLANNED ECONOMIES IN TRANSITION: INSTITUTIONS, ORGANIZATIONS, AND STRATEGIC CHOICE

MIKE W. PENG
University of Hawaii at Manoa
PEGGY SUE HEATH
University of Washington

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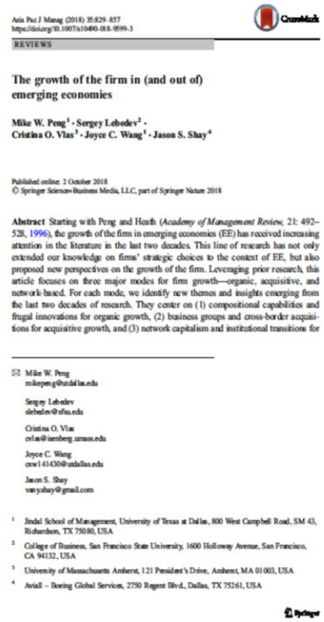
TWENTY (+) YEARS OF CHINA/EE RESEARCH

- Peng, Lebedev, Vlas, Wang, and Shay (2018 APJM): The growth of the firm in (and out of) emerging economies
- Since Peng and Heath (1996), network capitalism and institutional transitions for network-based growth have emerged as a major theme
- Cited Batjargal, Bruton, Burt, Opper, Walder ☺



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REVIEWS

The growth of the firm in (and out of) emerging economies

Mike W. Peng[1] · Sergey Lebedev[2] · Cristina O. Vlas[3] · Joyce C. Wang[1] · Jason S. Shay[4]

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Abstract Starting with Peng and Heath (*Academy of Management Review*, 21: 492–528, 1996), the growth of the firm in emerging economies (EE) has received increasing attention in the literature in the last two decades. This line of research has not only extended our knowledge on firms' strategic choices to the context of EE, but also proposed new perspectives on the growth of the firm. Leveraging prior research, this article focuses on three major modes for firm growth—organic, acquisitive, and network-based. For each mode, we identify new themes and insights emerging from the last two decades of research. They center on (1) compositional capabilities and frugal innovations for organic growth, (2) business groups and cross-border acquisitions for acquisitive growth, and (3) network capitalism and institutional transitions for

Mike W. Peng
mikepeng@utdallas.edu

Sergey Lebedev
slebedev@sfsu.edu

Cristina O. Vlas
cvlas@isenberg.umass.edu

Joyce C. Wang
cxw141430@utdallas.edu

Jason S. Shay
vanyshay@gmail.com

1 Jindal School of Management, University of Texas at Dallas, 800 West Campbell Road, SM 43, Richardson, TX 75080, USA
2 College of Business, San Francisco State University, 1600 Holloway Avenue, San Francisco, CA 94132, USA
3 University of Massachusetts Amherst, 121 President's Drive, Amherst, MA 01003, USA
4 Aviall – Boeing Global Services, 2750 Regent Blvd., Dallas, TX 75261, USA

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FIRST MAJOR EMPIRICAL STUDY ON *GUANXI*

- Peng and Luo (2000 AMJ): Managerial ties and firm performance
- Inspired by Mizruchi and Galaskiewicz's (1994) call to look for alternative contexts
- For the first time in the literature, separating managerial ties in two dimensions: (a) ties with top executives at other firms and (b) ties with government officials

MANAGERIAL TIES AND FIRM PERFORMANCE IN A TRANSITION ECONOMY: THE NATURE OF A MICRO-MACRO LINK

MIKE W. PENG
The Ohio State University

YADONG LUO
University of Miami

Using survey data from China, we demonstrate that managers' micro interpersonal ties with top executives at other firms and with government officials help improve macro organizational performance. This micro-macro link differs among firms with different (1) ownership types, (2) business sectors, (3) sizes, and (4) industry growth rates. In addition, managerial ties were found to be necessary but insufficient for good performance; a number of traditional strategy variables also drive performance. Theoretically, the findings point to the importance of the social context in which managerial ties are embedded. Empirically, this study provides the first set of quantitative data demonstrating both the extent and limits to which managerial ties are beneficial in a transition economy.

GUANXI VERSUS MARKET TRANSITIONS

- Peng (2003 AMR): Institutional transitions and strategic choices
- During the early phase of transitions: *Guanxi* is king!
- During the late phase of transitions: Switching to more market-based capabilities is a must
- Li, Peng, and Macaulay (2013 SO): Market-political *ambidexterity*


INSTITUTIONAL TRANSITIONS AND STRATEGIC CHOICES

MIKE W. PENG
The Ohio State University

FIRST MAJOR STUDY ON CORPORATE GOVERNANCE

- Peng (2004 SMJ): First China study in the mgmt literature using archival data
- Do outside directors make a difference in firm performance?
  - No, for financial performance (such as ROE)
  - But yes, for sales growth
- Agency theory-based "best practice" (such as appointing outside/independent directors) is highly *questionable*

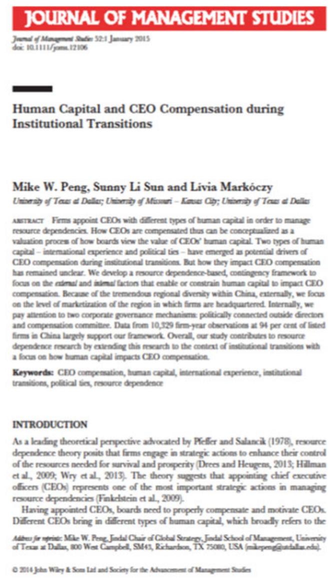

Strategic Management Journal

OUTSIDE DIRECTORS AND FIRM PERFORMANCE DURING INSTITUTIONAL TRANSITIONS

MIKE W. PENG*
Fisher College of Business, The Ohio State University, Columbus, Ohio, U.S.A.

A RECENT STUDY ON CEO COMPENSATION

- Peng, Sun, and Markoczy (2015 JMS): The impact of human capital (international experience vs. political ties) on CEO compensation
- Market transition theory: International experience +
- Power conversion theory: Political ties +
- Both seem valuable, with different moderating variables



JOURNAL OF MANAGEMENT STUDIES

Journal of Management Studies 52:1 January 2015
doi: 10.1111/joms.12106

Human Capital and CEO Compensation during Institutional Transitions

Mike W. Peng, Sunny Li Sun and Lívia Markóczy
University of Texas at Dallas; University of Missouri – Kansas City; University of Texas at Dallas

ABSTRACT Firms appoint CEOs with different types of human capital in order to manage resource dependencies. How CEOs are compensated thus can be conceptualized as a valuation process of how boards view the value of CEOs' human capital. Two types of human capital – international experience and political ties – have emerged as potential drivers of CEO compensation during institutional transitions. But how they impact CEO compensation has remained unclear. We develop a resource dependence-based, contingency framework to focus on the *external* and *internal* factors that enable or constrain human capital to impact CEO compensation. Because of the tremendous regional diversity within China, externally, we focus on the level of marketization of the region in which firms are headquartered. Internally, we pay attention to two corporate governance mechanisms: politically connected outside directors and compensation committee. Data from 10,329 firm-year observations at 94 per cent of listed firms in China largely support our framework. Overall, our study contributes to resource dependence research by extending this research to the context of institutional transitions with a focus on how human capital impacts CEO compensation.

Keywords: CEO compensation, human capital, international experience, institutional transitions, political ties, resource dependence

INTRODUCTION

As a leading theoretical perspective advocated by Pfeffer and Salancik (1978), resource dependence theory posits that firms engage in strategic actions to enhance their control of the resources needed for survival and prosperity (Drees and Heugens, 2013; Hillman et al., 2009; Wry et al., 2013). The theory suggests that appointing chief executive officers (CEOs) represents one of the most important strategic actions in managing resource dependencies (Finkelstein et al., 2009).

Having appointed CEOs, boards need to properly compensate and motivate CEOs. Different CEOs bring in different types of human capital, which broadly refers to the

Address for reprints: Mike W. Peng, Jindal Chair of Global Strategy, Jindal School of Management, University of Texas at Dallas, 800 West Campbell, SM43, Richardson, TX 75080, USA (mikepeng@utdallas.edu).

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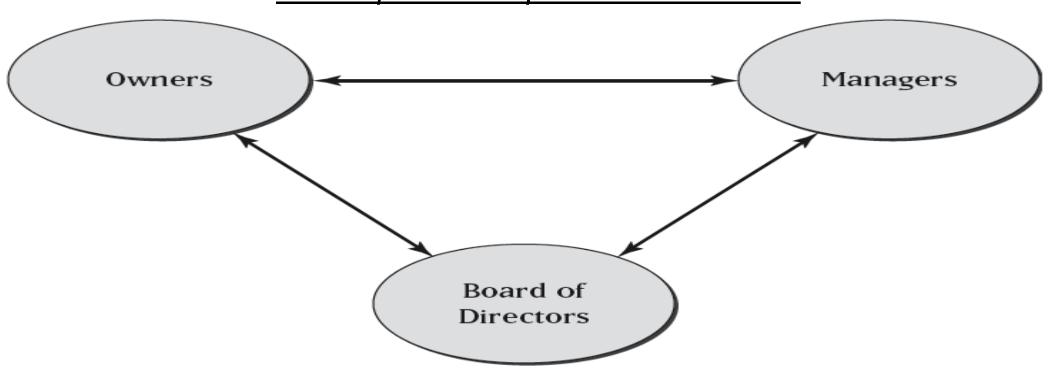
WHAT IS CORPORATE GOVERNANCE?

- The relationship among various participants in determining the direction and performance of corporations.

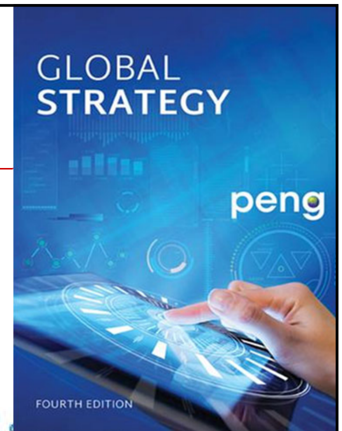
The Tripod of Corporate Governance



Source: Adapted from R. A. G. Monks & N. Minow, 2001, Corporate Governance *(cover), Oxford, UK: Blackwell.*

Figure 11.1

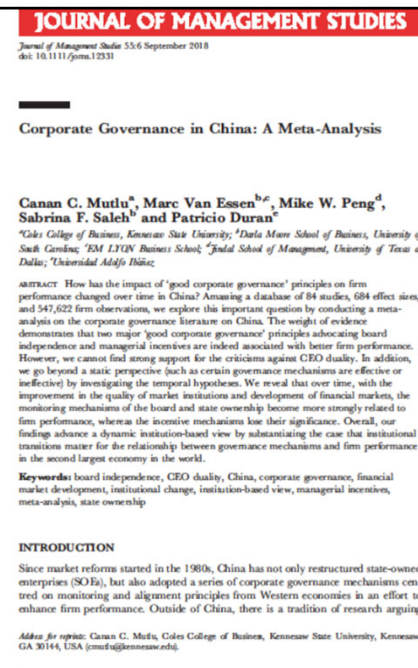
Opening case on CG



- Global competition in how to best govern large firms

CORPORATE GOVERNANCE IN THE LAND OF *GUANXI*

- Mutlu, Van Essen, Peng, Saleh, and Duran (2018 JMS): A meta-analysis
- Question 1: How do agency theory-prescribed "best practice"—(1) board independence and (2) removal of CEO duality—affect firm performance in China?
- Question 2: How do these relationships change as China's market institutions develop over time?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Corporate Governance in China: A Meta-Analysis

Canan C. Mutlu[a], Marc Van Essen[b,c], Mike W. Peng[d], Sabrina F. Saleh[b] and Patricio Duran[e]

[a]Coles College of Business, Kennesaw State University; [b]Darla Moore School of Business, University of South Carolina; [c]EM LYON Business School; [d]Jindal School of Management, University of Texas at Dallas; [e]Universidad Adolfo Ibáñez

ABSTRACT How has the impact of 'good corporate governance' principles on firm performance changed over time in China? Amassing a database of 84 studies, 684 effect sizes, and 547,622 firm observations, we explore this important question by conducting a meta-analysis on the corporate governance literature on China. The weight of evidence demonstrates that two major 'good corporate governance' principles advocating board independence and managerial incentives are indeed associated with better firm performance. However, we cannot find strong support for the criticisms against CEO duality. In addition, we go beyond a static perspective (such as certain governance mechanisms are effective or ineffective) by investigating the temporal hypotheses. We reveal that over time, with the improvement in the quality of market institutions and development of financial markets, the monitoring mechanisms of the board and state ownership become more strongly related to firm performance, whereas the incentive mechanisms lose their significance. Overall, our findings advance a dynamic institution-based view by substantiating the case that institutional transitions matter for the relationship between governance mechanisms and firm performance in the second largest economy in the world.

Keywords: board independence, CEO duality, China, corporate governance, financial market development, institutional change, institution-based view, managerial incentives, meta-analysis, state ownership

INTRODUCTION

Since market reforms started in the 1980s, China has not only restructured state-owned enterprises (SOEs), but also adopted a series of corporate governance mechanisms centred on monitoring and alignment principles from Western economies in an effort to enhance firm performance. Outside of China, there is a tradition of research arguing

Address for reprints: Canan C. Mutlu, Coles College of Business, Kennesaw State University, Kennesaw, GA 30144, USA (cmutlu@kennesaw.edu).

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INSIGHTS AND DEBATES FROM CHINA

- Strong economic growth despite relatively underdeveloped institutions
- Corporate governance reforms toward “modern enterprise system” since the 1990s
- Waging war on “best practice” in the *absence* of strong evidence (Peng, 2004 SMJ)
- In a relationship-based society, the applicability and effectiveness of arm’s-length monitoring and alignment may be questionable (Young, Peng, Ahlstrom, Bruton, & Jiang, 2008 JMS; Jiang & Peng, 2011 APJM).

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BOARD INDEPENDENCE

- China required publicly listed firms to appoint outside directors on corporate boards as of 2001 (Peng, 2004 SMJ)—*ahead* of SOX in the U.S.
- China’s relationship-based culture may affect board dynamics.
- Outside directors’ concern for reputation and credibility matters.
  - Outside directors tend to be more vocal when firm performance suffers or in case of corporate frauds (Ma & Khanna, 2013 SMJ).

- ***Hypothesis 1a.*** *Board independence is positively related to firm performance.*

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BOARD INDEPENDENCE OVER TIME

- The ratio of outside directors has increased from 6% in 2001 to 34% in 2005.
- Recent amendments have further expanded the role of outside directors through election mechanisms, terms of reference, and responsibility investigation in China (OECD, 2011).
- As market institutions improve, the sensitivity of outside directors for reputation and credibility in the labor market for directors may increase.

- ***Hypothesis 1b.*** *The relationship between board independence and firm performance becomes more positive over time.*

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CEO DUALITY

- Standard agency theory criticisms: CEO duality gives excessive power to the CEO
- Counterargument: In times of rapid change, CEO duality facilitates decision speed and eliminates top-level conflicts (Peng et al., 2007 MOR; 2010 APJM).
- Control versus collaboration (Krause, 2017 SMJ)

- ***Hypothesis 2a.*** *CEO duality is negatively related to firm performance.*

CEO DUALITY OVER TIME

- The performance effects of personal and political relations may diminish as market institutions prevail (Peng, 2003 AMR).
- The decline of the state's influence leads managers to be accountable to external market forces rather than to the state or political connections.
- ***Hypothesis 2b.*** *The relationship between CEO duality and firm performance becomes more negative over time.*

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META-ANALYSIS METHODS

- Four search strategies to identify studies:
  - Prior review articles.
  - Electronic databases: (1) ABI/INFORM Global, (2) EconLit, (3) Google Scholar, (4) JSTOR, and (5) SSRN.
  - Manual search of leading economics, finance, and management journals.
  - References of the retrieved studies.
- A final sample of 84 primary studies, 684 effect sizes, and 547,622 firm observations

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KEY FINDINGS

- H1a and H1b supported: A positive relationship between board independence and firm performance, which becomes stronger over time
- H2a not supported: A near zero relationship between CEO duality and firm performance
- H2b supported: The CEO duality-firm performance relationship does become more negative over time.

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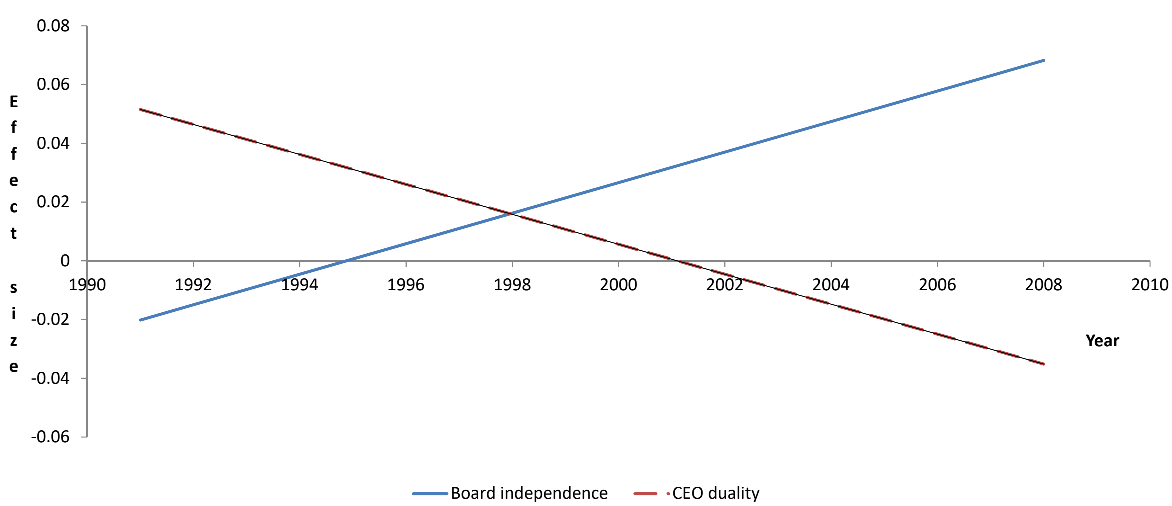
TEMPORAL EFFECTS



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IN THE GLOBAL CONTEXT

	Board independence	***CEO duality***
• Dalton et al. (1998: U.S. firms)	Near zero relationship	Near zero relationship
• Van Essen et al. (2012: Asian firms)	Near zero relationship	Near zero relationship
• OUR STUDY (Mutlu et al. 2018)	Positive relationship, which becomes stronger over time	Near zero relationship, which becomes more negative over time

- Relative to the U.S. and Asia, our meta-analysis actually finds that one best practice recommended by agency theory—board independence—is *more strongly* supported in China.

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CONTRIBUTIONS

- Providing the first meta-analysis on the rapidly expanding CG literature on China.
- Contributing to corporate governance research by showing that agency theory-prescribed "best practice" can help firm outcomes *over time*.
- Advancing a *dynamic* institution-based view (Peng et al., 2008 JIBS; 2009 AMP).

POLICY IMPLICATIONS AND FUTURE RESEARCH

- Earlier questions raised by Peng (2004 SMJ) and Young et al. (2008 JMS) on the advisability of enhancing board independence are answered
- From a policy standpoint, enhancing board independence is a +
- When waging war on best practice, be cautious with policy banning/discouraging CEO duality
- *Guanxi* between chairman of the board and the CEO remains fertile ground for future research (Krause, 2017 SMJ)
- CG will become more important with more SOE reforms and more internationalization efforts (including cross-listing) (Bruton, Peng, Ahlstrom, Stan, & Xu, 2015 AMP; Peng, Bruton, Stan, & Huang, 2016 APJM)

CONCLUSION

- As a "best practice," board independence is indeed helpful, and is more so over time
- But CEO duality continues to be a puzzle
- Corporate governance research is *guanxi* research
- CG by definition deals with the *guanxi* among three groups of players—managers, board directors, and shareholders
- From Peng and Heath (1996 AMR) to Peng et al. (2018 APJM), the growth of the firm in China (and emerging economies) requires a deeper understanding of crucial *relationships*