



Guanxi and corporate governance: Waging war on best practice

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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
- Triggered a wave of *guanxi* research

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

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Highlighting an important facet of diversity among organizations operating in different institutional environments, this article presents a model of the growth strategy of the firm in planned economies in transition such as Eastern Europe, the former Soviet republics, and China. Focusing on the organizational underpinnings, we explore the interaction between institutions and organizations to shape growth. Given the institutional constraints, neither growth expansion nor acquisition, two traditional strategies for growth found in the West, are viable for firms in these countries. Instead, firms settle on a network-based strategy of growth, building on personal trust and informal agreements to a strong network. The institutional environment that leads to this unique strategy of growth is examined, and boundary conditions, distinctions, and implications of this model are discussed.

An empirical problem of strategic growth in a planned economy is the performance consequences of firm size. (Chandler, 1932; Penrose, 1959). A stylized firm in this research stream is an organization that has substantial investments over the allocation of its resources and the formulation and implementation of its competitive strategies (Porter, 1980). What this literature assumes is that the firm operates in a market-based economy, is motivated to grow, and has a number of strategic choices that it can adopt to achieve growth (Chandler, 1932, 1954). It is unclear, however, whether such research applies to the West with any bearing on the firm in planned economies in transition such as Eastern Europe, the former Soviet republics, and China (Boynogolzier & Adner, 1991).

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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

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Human Capital and CEO Compensation during Institutional Transitions

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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 CEO's human capital. Two types of human capital – international experience and political ties – have emerged as potential drivers of CEO compensation during institutional transition. 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 Hegeman, 2013; Hillman et al., 2009; Wey et al., 2015). 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

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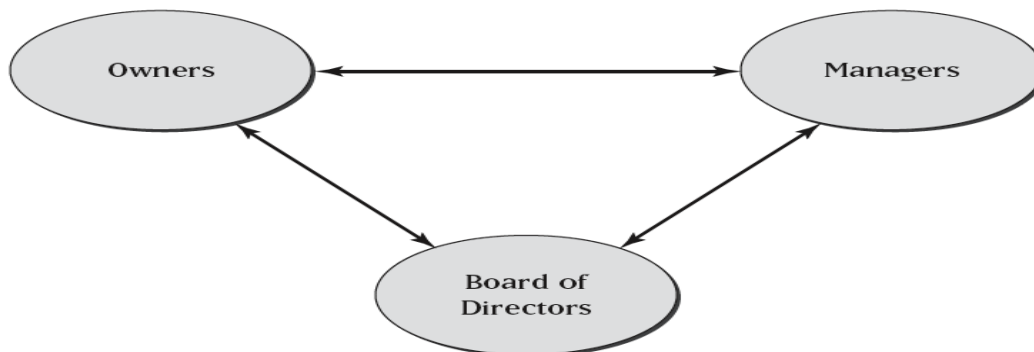
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WHAT IS CORPORATE GOVERNANCE?

- 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.

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Figure 11.1

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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

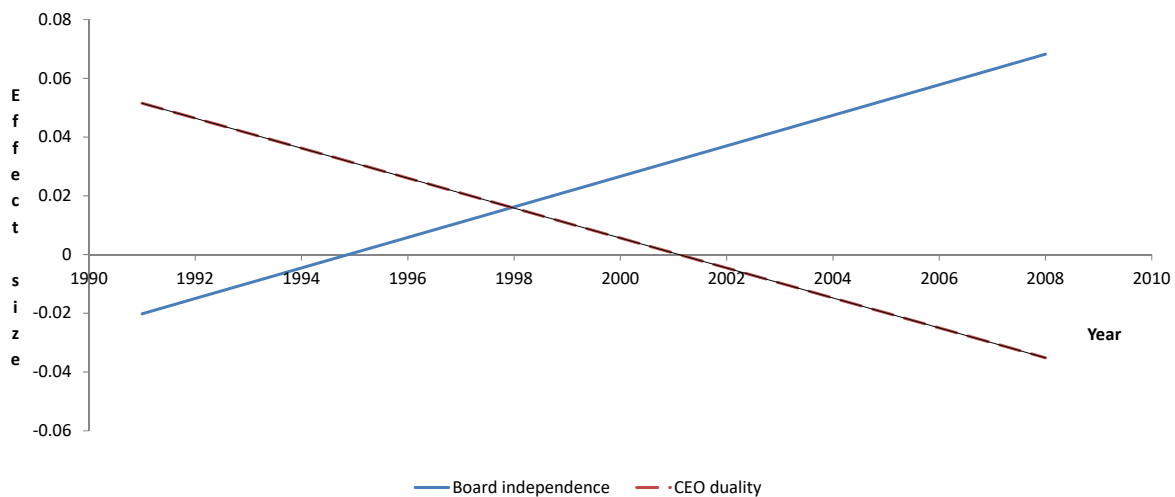
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KEY FINDINGS

- 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

- | | <u>Board independence</u> | <u>CEO duality</u> |
|--|---|---|
| • 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).

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POLICY IMPLICATIONS AND FUTURE RESEARCH

- 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 internationalization efforts (Bruton et al., 2015 AMP; Peng et al., 2016 APJM)

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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*

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