

PIERRE-OLIVIER LEGAULT TREMBLAY

Corporate Governance During Market Transition

Heterogeneous Responses
to Institutional Tensions in China



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*Corporate Governance in een veranderende markt:
Heterogene reacties op institutionele spanningen in China*

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*To my future grandchildren,
who will probably speak Mandarin...*

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CHAPTER 1 – GENERAL INTRODUCTION

1 CORPORATE GOVERNANCE: A RUDIMENTARY INTRODUCTION

How are firms governed? Ever since Berle and Means' (1932) treatise on *The Modern Corporation and Private Property*, the governance of large corporations is conceived through the separation between ownership and control. As opposed to owner managed firms in which the owner makes the decisions and claims the profits, stock listed firms involve shareholders that bring the capital and claim the residual profits, and managers to whom the administration of the firm is delegated. The benefits of the separation largely rest on the efficiency gains when the transaction costs involved in hierarchical decision making are lower than those of market mechanisms (Coase, 1937; Williamson, 1979). The relationship between owners and managers has been professionalized over time in formal corporate governance structures. Typically, the shareholders gather yearly in the shareholders' meeting to elect (usually on the basis of *one share one vote*) representatives among themselves that, on their behalf, oversee the management during the year. They form the board of directors. There has been abundant research on corporate governance, on the structure of boards, on the roles of directors and on the rules governing the shareholders' meetings (Bebchuk & Weisbach, 2010; Daily, Dalton, & Cannella, 2003). This body of research has led to prescriptions that have been integrated in corporate laws, stock exchange rules, companies' bylaws and in codes of corporate governance.

For long, the intellectual tradition of both the scholarship and the practice of corporate governance has been rooted in the specific context of and theorized according to the realities of American and British listed firms. While there is some domestic variety of ownership structures and despite some institutional features such as private contracting and *too big to fail* banks diverge from the theorized model, the dominant model observed in listed firms came to be seen as an ideal type at least in the US and the UK. Most large firms in these countries are characterized by dispersed ownership, which means that firms listed on the

stock exchanges often have a large number of shareholders that share the decision making rights. One of the inherent strengths of dispersed ownership rests in the disciplining effect of a market for corporate control (Butler, 1989; Easterbrook & Fischel, 1991). If a firm is poorly managed, it falls in value and may become the target of a hostile takeover by investors, with the aim of restructuring the firm, improve its management and regain value. Yet, given the separation between management and the board representing the interests of shareholders, the biggest challenge is to mitigate principal-agent problems between a firm's management and its large pool of shareholders (Jensen & Meckling, 1976). Agency problems arise when managers make decisions that are not in the best interests of shareholders. This may include empire building, whereby managers invest in projects that are not economically profitable. The solutions prescribed usually include the presence of independent directors on the board to avoid that executives control its agenda (Weisbach, 1988). Also, appointing a different person to the role of board chairman and of CEO helps ensuring a proper monitoring of managers. Implementing incentive compensation through stock options for managers also helps to align their personal interests with those of shareholders, namely maximizing the value for shareholders (Jensen & Murphy, 1990). This type of model can be called the outsider-control system (Franks & Mayer, 1997). It is usually found in countries with market based systems such as the US and the UK, where capital for investment in large firms is primarily drawn from the equity market.

But not all markets have dispersed ownership. In many countries, such as France, Germany and Japan, the law offers less protection to small shareholders (La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 2000). In this context, most firms remain under the control of a few insiders: large investors or often a single family. Then, the insiders are typically more involved in the operations as well, thereby reducing principal-agent problems. Firms in these systems often set up an additional board, the supervisory board, where key partners are invited to sit in order to coordinate their efforts to the benefit of the firm (Aoki, 1984). These partners, called stakeholders, may include members from the controlling family, representatives of employees, an agent from the bank, professors from a collaborating academic research center, etc. While agency problems are mitigated by the ownership concentration, a different challenge may arise from principal-principal problems in the form of tunneling (Johnson, Boone, Breach, & Friedman, 2000). Indeed, the controlling owner

may use the firm's assets to maximize its private benefits of control, such as employing family members regardless of qualifications or by investing in particular projects that allow them to achieve advantages in other ventures they control (Jiang & Peng, 2011). These decisions may have large opportunity costs and not offer the highest marginal returns to smaller shareholders. Such problems are partly mitigated by anti-self-dealing regulations (Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2008), and by the supervisory board that contributes to the long term orientation of corporate decisions (Aguilera & Jackson, 2003). This type of model can be called the insider-control system (Franks & Mayer, 1997). It is usually found in countries with bank-based systems such as Germany and Japan, where capital for investment is mainly channeled through financial institutions (Gilson & Roe, 1993).

These ideal-type models, dominant in the literature and practice across the OECD, provide normative bases to analyze the development of corporate governance regimes in other parts of the world as well. Yet, the starting point in most emerging countries that have embarked on lengthy processes of reforms to establish their own system differs substantially. For instance, transition economies with strong state sectors such as China, Vietnam and Russia face challenges that go far beyond principal-agent problems. Many firms are still ultimately controlled by the state, many private firms were born out of privatization of state assets, the legal system lacks independence and political elites are particularly influential (Allen & Shen, 2012; Oppen & Schwaag-Serger, 2008). Nonetheless, some of these countries have initiated regulatory reforms that try to implement features and rules of the West in a search for solutions to professionalize their corporate governance systems. There is a tension between the heavy heritage of government authority and the intention to empower external shareholders through legal reforms. The present doctoral dissertation aims to contribute to understanding whether and how firms' responses to this tension shape the emergence of a new stable corporate governance regime in a transition economy with a strong state.

In the remainder of this general introduction, section two reviews theoretical insights concerning complementarities, decoupling and heterogeneity that provide additional conceptual guidance about the emergence of new forms of corporate governance. Section three presents the case of China as a field that embodies the tension between inherited

institutions of political governance and recent efforts of professionalization of corporate governance. Section four presents the particular approach of configurational analysis, along with the methodology used in the operationalization of the empirical studies: fuzzy-set Qualitative Comparative Analysis (fsQCA). Section five summarizes the aims and contributions of each of the two main substantive chapters of the thesis, including a brief account of the findings and a comparison of the two studies.

2 A “COMPLEMENTARITIES” PERSPECTIVE ON REFORMS AND EMERGING GOVERNANCE FORMS

2.1 Complementarity and Incremental Change

During the last decade, a large part of the debate about corporate governance reforms has revolved around the convergence hypothesis. First put forward by Hansmann and Kraakman (2001), it predicts that listed firms around the world will ultimately all adopt the Anglo-American model based on agency theory prescriptions and dispersed ownership. The hypothesis has found some empirical support (Markarian, Parbonetti, & Previts, 2007), but has also been challenged on both conceptual and empirical grounds. Aoki (2001: 225) observes that the “institutional complementarity” in corporate governance is a force that sustains the diversity of systems internationally. Tarun Khanna (see Khanna, Kogan, & Palepu, 2006; Khanna, Palepu, & Sinha, 2005) also explains that systems of corporate governance consist of a number of complementary elements involving firm-level practices and contingencies from the institutional environment and the legal framework. Schmidt and Spindler (2002: 319) define complementarity as elements that “mutually increase their benefits [...] or mutually reduce their disadvantages or costs”, while consistency characterizes a system of which the constitutive elements fit together and “exploit the potential created by complementarity”. Höpner (2005: 332) further explains that in most fields, “complementarity refers to a constellation in which two (or more) elements must be combined to produce a particular outcome”. Taken together, these two definitions entail that complementarity concerns elements that are parts of a consistent system and that have mutually reinforcing causal relationships with an outcome. It has been argued that complementarities are a force for path dependency, preventing substantive reforms towards

an entirely new system. In this vein, Schmidt and Spindler (2002) propose that consistent systems are path dependent because of the costs associated with the risk of system wide disruption upon the reform of one element. While complementarities contribute to the persistence of a system, they may also represent its weakness. To the extreme, the definite disruption of a single element through internal tensions or external shocks can destabilize the overall consistency. Therefore, radical but isolated changes can hurt the system's effectiveness.

From this perspective, Schmidt and Spindler (2002) argue that only marginal improvements within a configuration can be implemented to reach a local optimum. This local efficiency peak may not be the highest when compared to the full range of possible systems. Only radical changes involving reforms of a critical mass of elements may justify the disruption costs associated with switching to another consistent system and achieve a new equilibrium. In practice however, reforms often concern only one or few marginal elements that can provide short term improvements towards the local optimum to satisfy political pressures from powerful constituencies and stakeholders (Schmidt & Spindler, 2002). In turn, institutional domains often display complementarities that reinforce the resulting predominant actors' interests in a virtuous circle (Aguilera & Jackson, 2003). According to the path dependency perspective, a wave of corporate governance reforms such as that witnessed in China in 2006 could either only achieve incremental improvements of the system towards a local optimum or trigger, after a system-wide disruption, a more fundamental realignment of elements under a new consistent system. Yet, even significant reforms in the books may fail translate into actual changes in practice.

2.2 Decoupling in Transition Economies

The particularity of transition economies such as China, Vietnam or Russia, with their imperfect regulatory framework, stems not from the law itself, but mostly from its low usage and weak enforcement. In the long run, improving the rule of law in capital markets can help reduce transaction costs (Williamson, 1979, 1991) and enhance predictability in dispute resolution (Cooter & Rubinfeld, 1989; Posner, 1973a, 1973b). While this may ultimately

apply to China, in the short run, Opper and Schwaag-Serger (2008) explain that legal reforms of corporate governance in China provide a perfect illustration for the mismatch between new laws in the books (de jure) and actual practices in the field (de facto). This has also been called *decoupling* (Fiss & Zajac, 2004, 2006), meaning that mere apparent compliance to the corporate law is sufficient and tolerated where enforcement is lacking or unfeasible (Fiss, 2007). In this context, “meaningful analysis of legal change in transition economies, such as China’s, [...] requires analysis of institutional frameworks that shape social behavior, which in turn explain the effectiveness of changes in the law” (Opper & Schwaag-Serger, 2008: 245). The changes in social behavior entailed by reforms in corporate governance touch on deeply rooted systems of central command and planning that can only slowly evolve into more decentralized structures of decision making to accompany the professionalization of management and its separation from ownership.

In addition, many legal prescriptions are not binding, but mere recommendations. They are ambiguous, in many cases intentionally. Dobbin and Sutton (1998) argue that specific legal compliance requirements are left in large parts for organizations to define, often consuming large amounts of resources in the process. So the practical applications of law in business activities are often shaped by a continuous negotiation process between actors. In other words, “legality¹ may originate in the external environment, but its meaning is often negotiated” (Edelman & Suchman, 2007: 10). In China, the Company Law textually states that the provisions are applicable unless the statutes of the corporation provide for different arrangements. In this sense, the implementation is largely left to the economic actors themselves. To be useful, the supply of law must follow the demand. “Despite impressive achievements in formal legal change, many transition economies have yet to learn how to use their new legal order effectively.” (Pistor, Raiser, & Gelfer, 2000: 357) So while it is important to implement “legal rules whose meaning can be understood and whose purpose is appreciated by domestic law makers, law enforcers, and economic agents, who are the final consumers of these rules” (Berkowitz, Pistor, & Richard, 2003: 192), the law only provides the backbone for contractual relationships resulting from constant renegotiation.

¹ According to Selznick et al. (1969: 11), the expression “legality” is interchangeable with the concept of “rule of law”.

2.3 Heterogeneity and Shifting Hierarchy in the System

Such a dynamic process of implementation of legal changes allows for substantial spontaneity and heterogeneity. Ahlering and Deakin (2007: 870) subscribe to the view that “complementarities often arise from unexpected contingencies or conjunctions” through an evolutionary process that, at the systemic level, cannot be planned. The constant renegotiation and adaptation by economic agents can affect the efficiency of specific elements of the system. Ahlering and Deakin (2007) consider that this unpredictable process is often self-reinforcing towards a contextually efficient system, suggesting that spontaneity may be compatible with path dependence. Still, this dynamic process that thrives towards a local optimum is expected to exhibit tensions among its elements. While the internal consistency among the elements of a system certainly contributes to stability, many scholars argue that even stable configurations of complementary elements are not static equilibria. Boyer and Saillard (2005) and Crouch and Farrell (2004) explain that complementarity and consistency can still carry some incoherency, redundancies and tensions between elements. Aguilera and Jackson (2003) propose that it is likely that the conflicting pressures that emerge from different domains of the institutional setting result in heterogeneity within a national market. Aguilera, Filatotchev, Gospel and Jackson (2008) observe that, while some complementarities can be hypothesized based on past theory, empirical evidence has shown substantial heterogeneity of combinations of practices across firms.

In addition, the constant process of renegotiation is likely to result in an equally constantly changing hierarchy among the elements of a system over time, and across cases. Even across firms with resembling consistent systems, the relative importance of complementary elements, or whether they are core or peripheral causal conditions, can vary. Höpner (2005: 342) explains that “a given institution shapes the organization of related institutions, but in an asymmetric way, with the hierarchy among institutions undergoing permanent change”. The relative importance of certain elements of the system evolves in different ways depending on the relations between the particular economic agents involved in a transaction. Such variations are expected to contribute to the domestic diversity. Aguilera et al. (2008)

suggest that the variety of configurations in a given market can be important to provide the grounds for future adaptation. This proposition is in line with Stark's (2001) argument that national variety of combinations (or recombination) of practices can provide flexibility. While a number of economic agents might achieve a local optimum, there is the possibility that other economic agents adopt suboptimal systems that, while less efficient in the short run, may prove to be more compatible with forthcoming large scale legal reforms. Domestic heterogeneity, it follows, would prevent system wide disruption while the regime could accommodate for experimentation with a variety of systems concurrently.

To sum up, given that firms seek to take advantage of the complementarities offered by different elements of the system, given that implementation of reforms is often negotiated among the actors, and given that the hierarchy of elements is context-specific, the shape of the corporate governance regime in China is influenced by the heterogeneity of governance structures adopted by firms in response to the institutional tensions between the inherited tradition of political control and recent market oriented reforms. The present doctoral dissertation dives into the issue of heterogeneity to analyze the main corporate governance forms that have emerged and whether they can allow firms to mitigate corporate governance problems and achieve performance in the context of institutional tensions.

3 EMPIRICAL CONTEXT: CHINA AND THE LISTED SECTOR

The field of corporate governance in China in the past decade, with the rapid evolution of the institutional framework, offers a particularly interesting ground for scholarly work on the influence of significant legal changes on the effectiveness of corporate governance practices. The Chinese government has set the professionalization of corporate governance in the listed sector as a high priority. The tension between these reforms and the inherited institutions of political governance is particularly salient. This section provides a detailed account of the recent wave of corporate governance reforms put forward in China. It then presents a description of the population of Chinese listed firms, with an emphasis on the ownership structures and a discussion of the resilience of political control at the firm level.

3.1 Corporate Governance Reforms in China

Prior to the reform era, the management system in China made no distinction between political governance and corporate governance. As the Chinese state embarked on the road of massive economic transformation and liberalization, corporations also slowly started to separate the functions between managers and owners and to develop economic performance criteria. Allen and Shen's (2012) view is that unlike centuries old stock exchanges in New York, London or Amsterdam, China's did not emerge out of transactional routines and agreements between merchants and capitalists, but was rather carefully crafted from scratch by the state from top-down and effectively launched on a complete pre-existing regulatory framework that was not based on norms negotiated in the marketplace. Created in the early 1990s, the Shanghai and Shenzhen Stock Exchanges were planned, designed, controlled. They were primarily created to provide the central government with an avenue to achieve massive waves of privatizations in the large state sector (Allen & Shen, 2012).

It took roughly 25 years before the emergence of a real push towards standardization and professionalization of corporate governance. The first significant interventions by the state in this regard came in the form of a *Code of corporate governance* for listed firms in 2002 and the *Establishment of Independent Director Systems by Listed Companies Guiding Opinion* in 2001 mandating the appointment of a proportion of 33% of independent directors on the board of directors, both issued by the China Securities Regulatory Commission (CSRC). This prescription was a direct transplant of corporate governance practices developed and promoted in Western countries. In the run up to the adoption of the new securities and company laws, the state started forcefully advocating for the implementation of international best practices. In the 2004 *Opinions of the State Council on Promoting the Reform, Opening up and Steady Growth of Capital Market*, the importance of “safeguarding the legitimate rights and interest of investors, especially those of public investors”² is mentioned no less than seven times.

² Guo Fa [2004] No.3, issued on January 4th, 2004. Section II. Available at: http://www.csrc.gov.cn/pub/csrc_en/laws/rfdm/AdministrativeLaws/200907/t20090729_119391.html

These principles were formally integrated into the legal framework with the enactment of the reformed Company Law and Securities Law. These were new versions of the two most important laws regulating large firms in China first enacted in 1993 and 1998 respectively. Major reforms to both laws were adopted in 2005 during the tenth National People's Congress and became effective on January 1st 2006, with an aim to level the Chinese system closer to international standards. At once, of the 229 provisions of the old Company Law, 60% were amended, another 20% were deleted and 41 new provisions were created. Of the 214 provisions of the Securities Laws, 40% were amended, 13% were deleted and 27 new provisions were included. This produced a major change in terms of compliance requirements for firms and also a powerful signaling effect on the expectations towards management and governance improvements in the Chinese corporate market. "The newly revised Company Law regulated the governance structure of listed companies, set forth strict legal obligations and responsibilities for listed companies and related staff" and the revised securities law "increased supervision of securities companies, established the securities investor protection fund system, improved the securities regulatory management system, and increased legal liabilities imposed on violators in securities market." (Chen, 2009: 21) The law greatly expanded the civil liability of wrongdoers, including executives, directors, supervisors, auditors and exchanges. Investors were even allowed to sue directors for fraudulent actions that had taken place prior to the law's promulgation.

These two laws became the bedrock for a wave of additional provisions and regulations to consolidate and specify the legal regime under which the securities market is operating. In 2006, amendments were made to the Criminal Law providing the basis for charges in the securities market and the means to judicial authorities to enforce the new measures set forward in the securities and company laws. Authorities were given explicit power to punish insider trading, partial disclosure, stock manipulation and many other actions that hurt the interests of shareholders. Also in 2006, the CSRC established the Administrative Sanctions Committee to investigate alleged violations and the Ministry of Finance issued the new *Chinese Accounting Standards for Business Enterprises* and the *Auditing Standards for Certified Public Accountants*. In 2007, the CSRC issued the *Regulations on Information Disclosure of Listed Companies*, followed by the release of specific disclosure rules by both the Shanghai and the Shenzhen Stock Exchanges.

Consistent with the idea that quality information disclosure must be available to external investors in order to generate accurate stock prices, a particular emphasis was put on disclosure to support market efficiency. While the CSRC has been actively trying to instill more discipline (Allen & Shen, 2012), academics and practitioners do not ascribe much trust to data disclosure in China. Indeed, the results of a study conducted by the Shanghai Stock Exchange indicate that “disclosure violations represented approximately 78% of all violations punished by the CSRC and two stock exchanges for the period of 1996-2007” (Allen & Shen, 2012: 169). With the new laws, listed firms are required to disclose truthfully and timely any information that may have material consequences for shareholders. Also, disclosure of detailed compensation of directors individually was mandated from 2006 onwards (Conyon & He, 2011). False or omitted information is to be sanctioned. More generally, the CSRC launched in 2007 a compulsory corporate governance self-assessment process in which firms were required to document and release the details on the extent of their compliance with the new rules, justify the gaps and set improvement targets (Lu, Zhong, & Kong, 2009).

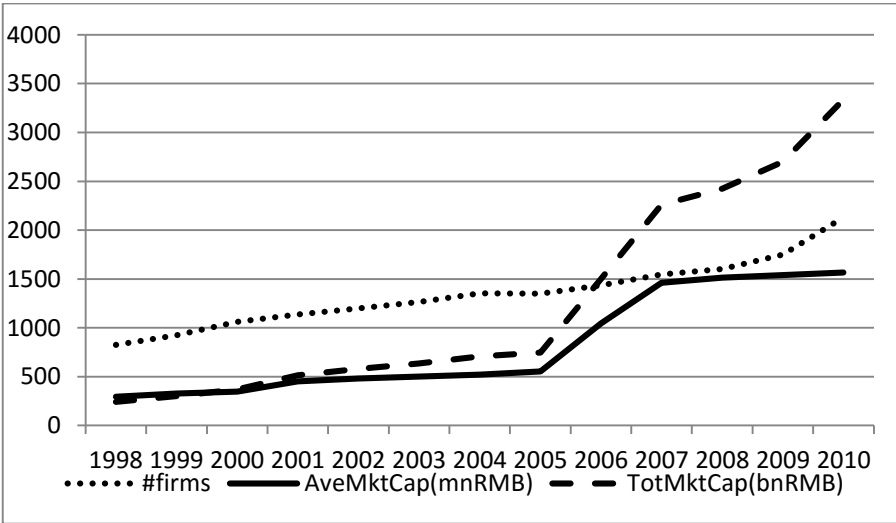
These laws were accompanied by a number of initiatives that reinforced the strength of the signal sent by the Party leadership to the market about their commitment to improve corporate governance in the marketplace. Many of these initiatives took the form of collaborations with international institutions on the implementation of better standards. Among others, the OECD has supported the production of lengthy self-assessment reports on the implementation of the OECD principles of corporate governance. Also, the International Financial Corporation (World Bank) has been involved in several large Chinese firms to assist with the implementation of firm-level reforms. In 2005, ahead of the enactment of the new Company Law and Securities Law, then Chairman of the IFC Javed Hamid declared in front of a large political and financial crowd in Shanghai that “well governed companies are directed by their boards, have mechanisms for protecting minority shareholders, and are transparent” (Hamid, 2005). Finally, the CSRC is member of nearly every consultative committee of the International Organization of Securities Commission (IOSCO). Along with Brazil and India, China was invited to sit on the IOSCO’s Technical Committee responsible for establishing the international securities regulatory standards. As

of 2014, the CSRC also holds the Vice-Chairmanship of the IOSCO Committee on Investment Management.

3.2 The Rise of Chinese Listed Firms and the Resilience of Political Control

As it can be seen in figure 1 below, the number of listed companies has increased gradually over the years, with a slight acceleration from 2008 onwards. During the two years that followed the enactment of the new Securities Law and Company Law, the average Chinese listed firm nearly tripled in market capitalization. While the global financial crisis moderated this trend, the total market capitalization in the two Chinese stock exchanges kept increasing steadily, fuelled by a wave of new initial public offerings (IPOs). The last decade has seen Chinese stock exchanges produce very large IPOs. At the time of their listing, the Agricultural Bank of China in 2010 and the Industrial and Commercial Bank of China in 2006 were the largest IPOs ever recorded in any market with respective values of 22.1 and 21.9 billion dollars.

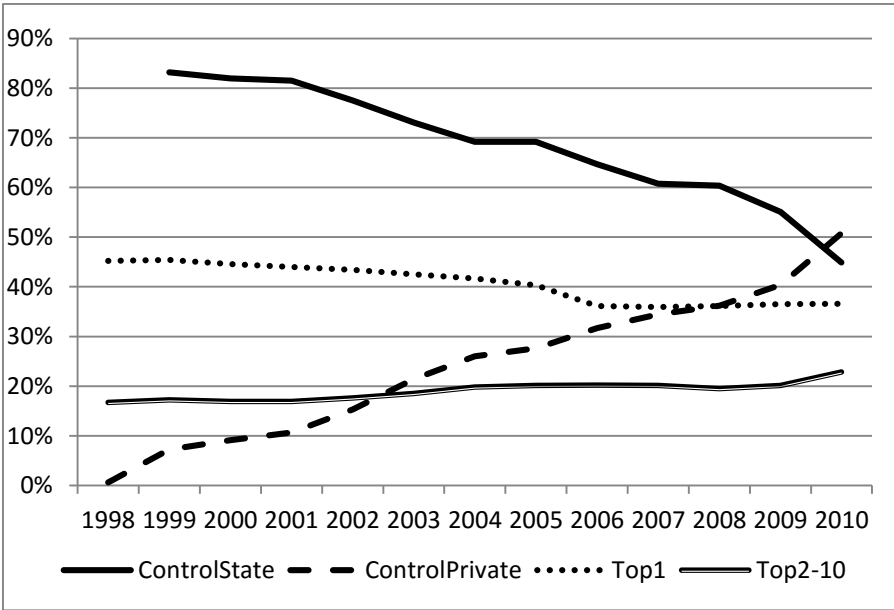
Figure 1. Stock market development in China³



³ Own calculations using data from WIND database. See unit in parenthesis to interpret each series on the vertical axis.

Figure 2 shows the evolution of ownership structures over the period from 1998 to 2010. In 1999, more than 80% of all listed firms were controlled by the state. The downward trend mirrors the rise of private firms (firms of which the ultimate controlling owner is a private party), which ultimately surpassed SOEs by the end of the decade. Nevertheless, about 45% of listed firms were still controlled by a government agency in 2010. Figure 2 also shows the evolution of the average ownership concentration. *Top1* represents the average proportion of shares held by the largest shareholder. There was a reduction of about 10% between 1998 and 2006, but the percentage stabilized since 2006 around 35% of shareholding. *Top2-10* tracks the average sum of shareholding of the second to tenth largest shareholders. The value is remarkably stable across time, with a modest trend upwards although remaining substantially below the average proportion held of the largest shareholder.

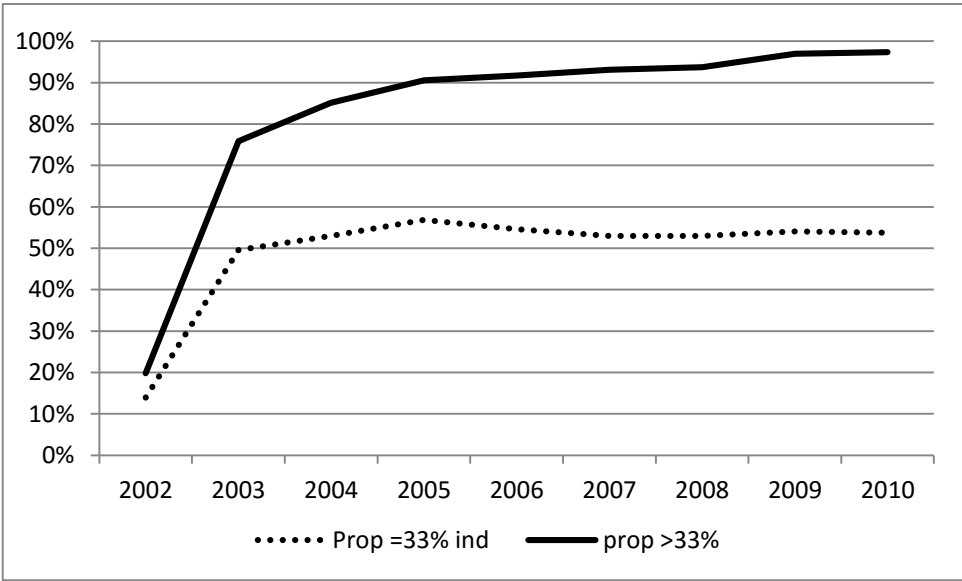
Figure 2. Ownership in Chinese listed firms⁴



⁴ Own calculations using data from CCER-PACAP database. The vertical axis indicates the average proportion of ownership.

In terms of professionalization of corporate governance practices, a majority of firms implemented the most basic prescriptions over the decade. For instance, figure 3 presents the proportion of firms that complied with the rule enacted in 2002 mandating a minimum of 33% of independent directors on their board. Already in 2003, nearly 80% of firms had complied. By 2010, only a few exceptions were in breach. Since 2003, about half of the firms maintain the exact minimum of 33%, while the other half went beyond the legal requirement. The creation of special committees of the board followed a similar trend. Over the decade, these committees went from being virtually absent from boardrooms to being the norm. The audit committees and the compensation committees were the fastest to develop, covering less than 1% of firms in 2000, around 50% in 2005 and more than 99% in 2010. The committees of strategy and of nominations also developed quickly, covering around 75% of firms by 2010.

Figure 3. Listed firms’ compliance with rule on independent directors⁵



Yet despite these instances of professionalization and despite the steady decrease in the proportion of firms formally controlled by the state, the Communist Party of China (CPC)

⁵ Own calculations using data from GTA Corporate Governance database. The vertical axis indicates the average proportion of independent directors on the board.

and the political elite maintain an influence that is felt far beyond these official numbers. The Chinese system is rooted in a past of political governance. In the 1980s, even when formal decision making did not rest in the hands of political agents, the administrative monopoly held by the government which is not unique to China but particularly salient could be used to extract rent from entrepreneurs and managers investing in private businesses, creating a hold-up problem. Che (2002: 789) observes that the government's power over firms was most prominent in the allocation and control of “various inputs, such as land, electricity, water, licensing, and financial capital”. Using the emergence of township and village enterprises (TVEs) as an example, he finds that local government ownership could act as a “second best commitment” to curtail rent-seeking behavior by the local government itself and incentivize private business investment. Hsiao, Nugent, Perrigne and Qiu (1998) also observe that local governments had substantial power over the allocation of resources, especially energy and market access, in TVEs early during the reform era. From 1985 to 1989, no less than 50% of TVEs' production was sold to SOEs. The role of local state agencies in this context, although accompanied by considerable moral hazard and discretionary power, was important to provide market clearance and resources that ill-functioning markets could not deliver.

In the 1990s, political influence started adapting to the new corporate structures that accompanied the rise of the listed sector. Fan, Wong and Zhang (2007) studied 790 companies from 1993 to 2001 and found that about 27 percent of CEOs were current or former government bureaucrats. Li, Meng and Zhang (2006: 560) observe that private entrepreneurs in China have a tendency to seek formal political participation to obtain resources. By doing so, they “can obtain resources that are not accessible through markets; they can circumvent government regulations; they can secure tax deductions and obtain legal or nonlegal protection for their businesses”. Li et al. (2006) measure political participation by formal membership in the People's Congress and the Chinese People's Political Consultative Conference. They find that the likelihood of a private entrepreneurs membership in one of those bodies decreases by 8% to 20% with an improvement of one

standard deviation in the institutional index⁶ (see Fan & Wang, 2003), which suggests that political participation is an effective surrogate for well-functioning market institutions.

During the last decade, the empirical evidence continues to show the important role of political agents in business. In 2010, among 2139 listed firms, 50% were found to have at least one individual in a top position (top executives, directors, supervisors) concurrently holding an official political position outside the firm⁷. Among private firms, 35% displayed such political connection. Among those politically connected private firms, 38% had a politically connected leadership (Board Chairman or CEO).

4 APPROACH AND METHOD

This doctoral dissertation studies a population of listed firms that are embedded in inherited institutions of political governance while facing new challenges brought by a wave of legal reforms tailored on international best practices and aiming at professionalizing corporate governance. The China of the last decade represents a timely and interesting case to study how firms respond to such tensions between seemingly conflicting institutions that are simultaneously constraining and enabling. In such a dynamic environment, one cannot expect a complete and detailed blueprint of institutions. While this is true everywhere in the world, the effect of decoupling between regulation and practice as well as the evolving complementarities among elements of the system suggest that China may present an acute level of heterogeneity of firm-level governance models. Some models may approach the ideal-type systems presented earlier, but it is reasonable to expect that the spontaneous and creative process of recombination sparked by the institutional tensions has led to novel ways to tackle problems and achieve performance.

The two main substantive chapters of this dissertation are structured around two core questions pertaining to corporate governance in China. Chapter 2 studies the most salient

⁶ Fan and Wang (2003) have designed the “NERI index of marketization of China’s provinces”, which incorporates sub-indicators that measure components such as the size of government, tax burden on enterprises, non-state share in employment and investment, bank loans to private firms, share of lawyers and accountants per population, number of patents, etc.

⁷ Own calculations and coding using data from GTA Corporate Governance.

corporate governance problem, namely the controlling shareholder expropriation problem which stems from principal to principal relationships. Chapter 3 documents the heterogeneous forms of corporate governance observed in China, including features of political embeddedness, and how they relate to firm performance. Taken together, these two empirical studies aim at understanding how firms subject to institutional tensions achieve performance and resolve problems.

Following the insights from the literature on complementarities and heterogeneity, these issues of corporate governance are studied through a research design using configurational analysis. While this approach is suited to the empirical setting presented above, it is also in line with recent developments in corporate governance research. Short, Payne and Ketchen (2008) argue that approaches studying multiple interactions would help resolving equivocal results in the literature. Indeed, corporate governance is increasingly conceived as bundles of mutually reinforcing practices (Aguilera et al., 2008; Rediker & Seth, 1995). Firms adopt structures that offer synergies with their institutional environment (Aguilera, Kabbach-Castro, Lee, & You, 2012). Across bundles, distinct practices may act as substitutes, effectively offering firms with alternatives between functional equivalents (Demsetz, 1983; Misangyi & Acharya, 2014). It may also be the case that a critical mass of elements from one bundle, as opposed to the adoption of every practice of the bundle, is sufficient to achieve the outcome (Garcia-Castro, Aguilera, & Arino, 2013).

Such configurational analysis does not completely depart from the classical contingency theory first proposed by Chandler (1962) which claims that a firm's structure is the product of its strategy. In this vein, Mintzberg (1979) famously documented five structural configurations while emphasizing that organizations are complex and that decision making is often unstructured and iterative. Embedded in the proposed multiplicity of configurations is the idea that managers and organizations need flexibility because problems are also flexible. The configurational perspective addresses a number of critiques voiced in the literature on the structure-performance paradigm (see Galunic & Eisenhardt, 1994), calling for more inductive studies and for approaches that can account for the often complex relationships involving more than one contingency simultaneously, which a bi-variate method does not allow.

The configurational analysis adopted here enables an inductive approach to the study of complex interaction effects involving multiple elements. Short et al. (2008) define two types of configurations that are based on organizational features. Archetypes are context specific, usually according to industries, and share certain features including “strategy, structure, process, size, and culture” (Short et al., 2008: 1056). Organizational forms are more generalizable configurations that span several industries. Based on this taxonomy, and since the questions studied in this thesis are not driven primarily by industry specific contexts, the configurational patterns discussed here could be labeled as corporate governance forms.

Set theoretic methods have been identified as a promising avenue to study the causal complexity and the subtle complementarities in bundles of corporate governance practices (Aguilera et al., 2008; Filatotchev & Allcock, 2010). In particular, the fsQCA software developed by Ragin, Drass and Davey (see also Ragin, 2000, 2008a; 2006) is increasingly used in the literature for empirical studies on corporate governance (Bell, Aguilera, & Filatotchev, 2013; Garcia-Castro et al., 2013; Misangyi & Acharya, 2014). Set theory conceives the elements of a system as conditions that are either absent or present. The intersection between the sets of many conditions and the outcome set allows the identification of configurations of conditions that lead to the outcome. Set theory therefore integrates the notion that a given outcome may not have a single cause (Greckhamer, Misangyi, Elms, & Lacey, 2008). That several causal paths can lead to the outcome is called equifinality (Fiss, 2007). This is particularly useful to the study of heterogeneity of configurations. It also facilitates the study of multiple interactions within bundles. In addition, set theory allows for causal asymmetry, which means that the presence of an element may contribute to the success of one configuration while the absence of the same element is required for another configuration to work (Fiss, 2011; Ragin, 2008a).

The subtle treatment of interaction effects in fsQCA offers advantages compared to other research designs. In particular, research on the effect of corporate governance often makes use of indices, bundling many practices into a single indicator of good governance (Bebchuk, Cohen, & Ferrell, 2009; Cheung, Thomas Connelly, Limpaphayom, & Zhou, 2007; Gompers, Ishii, & Metrick, 2003). Indices can be useful to establish a normative measure that is comparable over time, that can be generalized to large populations, and that can

aggregate the construct and allow for parsimonious quantitative analysis. However, the strengths of indices also represent their weaknesses. For instance, Lu et al. (2009) develop an index based on the OECD corporate governance guidelines, but specifically adapted to the Chinese market and divided into 6 sub-sections. For them, “the logic behind this approach is that corporate governance mechanisms might be substitutes for one another. Consequently, one must consider the overall quality of corporate governance when examining the impact on a firm’s performance” (Lu et al., 2009: 84–85). While the diagnostic that practices can be substitutes fits the conception adopted here, the remedy of mixing them effectively leads to losing sight of their distinct effects.

Another problem appears in studies that incorrectly present their findings in terms of configurations. For instance, Lo, Wong and Firth (2010) report that independent directors or the separation of board Chair and CEO positions or financial expertise in the audit committee can deter the manipulation of transfer prices during related party sales. Their usage of the word “or” wrongly suggests that each of these three conditions is a sufficient functional equivalent, although their OLS regression method cannot convey such findings. Configuration analysis, using Boolean logic and vocabulary, allows a careful analysis of interactions that can support findings that include “ANDs” (complementarities) and “ORs” (substitutes).

5 AIMS AND STRUCTURE OF THE DISSERTATION

The remainder of this doctoral thesis is organized in two substantive chapters and a general conclusion, which discusses the general takeaway and offers propositions for future research. After summarizing the aim of each of the two main chapters of the thesis, this section ends with a comparison of the two studies and a short discussion of the general takeaways. It is important to note that the two main chapters are written as stand-alone studies that, while offering a consistent whole, maintain full coherence if read separately.

The population of firms analyzed in the empirical studies of both chapters Chinese firms with standard A shares listed on the two main Chinese stock exchanges: the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE). The dataset for chapter 2

(Principal-principal relationships at the core of corporate governance problems in China: A set theoretic analysis) consists of 1337 firms. The data was gathered for the year 2005, since it is the last year for which the outcome variable was disclosed and readily available. The study covers the entire population at the time (99%), leaving only a few cases because of missing or inconsistent data. The dataset for chapter 3 (*Political Embeddedness and Corporate Governance: Heterogeneity and Hybridization in China*) consists of 810 SOEs and 942 private firms, studied in two separate groups. All the data concerns the year 2010. In order to maintain the comparability of results between SOEs and private firms and to facilitate the interpretation, the industries where SOEs were too dominant or not present enough were removed. This strengthens the comparative focus between the state sector and the private sector which more closely embodies the institutional tensions and reduces the potential industry-specific bias induced by sectors that are nearly entirely structured around state agencies. The five industries that were removed are timber and furnishing, finance and insurance, mining, utilities and transportation.

5.1 Principal-Principal Relationships at the Core of Corporate Governance Problems in China: A Set Theoretic Analysis

While most of the corporate governance literature concerns the mitigation of principal-agent problems in markets with dispersed ownership (Daily et al., 2003; Fama & Jensen, 1983), the most salient corporate governance problem in Asia and many emerging markets rests in the controlling shareholder expropriation problem (Chen, Li, & Shapiro, 2011). The presence of a large controlling owner allows the insiders to use corporate assets to reap disproportionate private benefits of control to the detriment of the small investors' wealth maximization (Claessens, Djankov, & Lang, 2000). Such principal-principal problems are not unique to China or other emerging markets, as they are also a concern in continental Europe where many firms still have concentrated ownership (Faccio, Lang, & Young, 2001). Still, these problems in China are distinct because of the particular impact of the state in two main ways. The state still directly controls a large proportion of listed firms, and it also has an indirect impact on all firms through anemic implementation and enforcement of legislation. The enduring role of the state embodies the inherited norm of common property

regimes (Ostrom, 1990), which involves constant renegotiation of decision making rights among principals (Stark, 2001). In this context, chapter 2 aims to understand the conditions under which the controlling shareholder in Chinese firms has the incentive and the ability to expropriate cash flow from the firm.

The most common form of expropriation occurs through tunneling, a diversion of assets from the firm to another corporate entity controlled by the same group of insiders (Johnson et al., 2000). These dealings are often referred to as related party transactions. In the case of China, the most common tunneling transaction takes the form of inter-firm loans (Jiang, Lee, & Yue, 2005). The model used in chapter 2 therefore adopts a measure of inter-firm loans as the outcome variable. Then, four types of conditions are identified as potential contributors to the occurrence of tunneling.

- a. The ownership structure: The proportion of shares held by the largest shareholder gives a measure of his income rights and his incentives to expropriate cash flow (Claessens, Djankov, Fan, & Lang, 2002; La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 2002). The presence of large minority investors may enhance monitoring on insiders or enable tunneling if there is collusion at the top of the ownership structure (Faccio et al., 2001). A low floating ratio (proportion of tradable shares) may hinder disciplining market mechanisms and increase the insiders' incentives to engage in tunneling (Chen, Chen, & Wei, 2009).
- b. Control by the state: State control does not intrinsically increase tunneling incentives. State ownership may add a layer of external monitoring on insiders (Lo et al., 2010), but it may also bring objectives that diverge from the maximization of small shareholders' wealth (Shleifer & Vishny, 1994).
- c. Commitment to best practices of corporate governance: Three elements are included in the model to assess the effectiveness of corporate governance practices to mitigate tunneling behavior, namely whether there is a critical mass of independent directors on the board (Hayward & Hambrick, 1997), whether the firm has a rigorous internal audit mechanism and whether the firm engages in proactive disclosure (Liu, 2006a; Xie, Davidson III, & DaDalt, 2003).
- d. Financial factors: The literature is mixed about the effect of firm size on principal-principal problems. Large firms may become transaction hubs facilitating tunneling

(Yeh, Shu, & Su, 2012), but the governance structure of small firms is usually less geared towards accountability (Aguilera et al., 2008). High firm indebtedness (high leverage) has been identified in the literature as a strong determinant of tunneling (Jiang, Lee, & Yue, 2010).

Following the recent work of Garcia-Castro et al. (2013) and Misangyi and Acharya (2014) on the possibility that elements of corporate governance may be simultaneously complements and substitutes, a number of guiding propositions are drawn. Chapter 2 adopts an inductive approach, although these guiding propositions are used to explicitly relate the findings with the predictions from the literature on principal-principal problems and assess how they apply to the Chinese case. Generally, the findings suggest that the main incentives and mechanisms driving tunneling behavior by insiders involve a three-way interaction between a low proportion of shares by the largest shareholder, a small firm size and high indebtedness. Any two of these three conditions seems sufficient to provide the incentives and mechanisms for insiders to engage in tunneling. This finding is symmetric since these conditions are absent in most configurations that do not produce tunneling. If these conditions are present, a lack of commitment to best practices of corporate governance acts as an enabling factor for tunneling, especially the absence of proactive disclosure. Yet, in the absence of tunneling incentives, the implementation or not of best corporate practices does not matter. Also, an independent board is found to provide an enabling mechanism for collusion towards tunneling in firms with large minority investors and those controlled by the state.

These findings contribute to the literature in several aspects. They provide a finer understanding about the contractual relationships and governance structures that can effectively align the interests of multiple principals in a transition economy. The results show that investors in both private firms and SOEs should be concerned with principal-principal problems, but that the conditions enabling tunneling might differ. The empirical literature on principal-principal problems in Asia had offered very equivocal results. Using configuration analysis allows unraveling the causal complexity and asymmetry of the relationship between elements of corporate governance models and tunneling behavior. These findings confirm that conditions may at the same time be complements and substitutes

(i.e. the presence of any two out of three conditions is sufficient in the tree-way interaction). This emphasizes the importance of studying corporate governance structures as bundles of inter-related elements instead of isolating the effect of individual practices.

5.2 Political Embeddedness and Corporate Governance: Heterogeneity and Hybridization in China

As explained earlier in this chapter, Chinese firms have to deal with a substantial wave of recent reforms of corporate governance legislation aimed at professionalizing their practices (Qian & Wu, 2003). At the same time, these market based reforms are implemented within an institutional context of political governance inherited from a socialist past (Allen & Shen, 2012). A large proportion of firms are still ultimately controlled by state agencies and, even in private firms, the influence of the Communist Party of China (CPC) is felt through networks of political connections among top executives and directors. Indeed, through the Party Nomenklatura, the state maintains a firm grip on the career path of many top officers within the corporate elite (Brødsgaard, 2012). The influence of informal mechanisms is strengthened by the decoupling between *de jure* legislation and *de facto* practices (Opper & Schwaag-Serger, 2008). Interestingly, the literature, which can be synthesized using the metaphor of the helping hand and the grabbing hand of the state (Frye & Shleifer, 1997), provides very equivocal results about the effect of political connections on firm performance. In this context, chapter 3 offers an exploratory study that aims to uncover the actual corporate governance configurations employed by both private firms and SOEs to achieve firm performance.

The two ideal-type models proposed by Franks and Mayer (1997) and discussed at the beginning of this introduction are used as a starting point for the analysis: the insider-control system and the outsider-control system. Three conceptual building blocks are added to complement this starting point. Firstly, scholars increasingly recognize that the heterogeneity of systems documented at the international level by the comparative corporate governance literature (Aguilera & Jackson, 2003, 2010) may also be observed at the domestic level across firms (Krug & Hendrischke, 2012; Meyer, Estrin, Bhaumik, & Peng, 2009; Peng, Wang, & Jiang, 2008; Whitley, 2006). Secondly, the theoretical work of Streeck

(2001) on complementarities along with accounts of recombination in China (see Boisot & Child, 1996; Nee, 1992) suggest that firms may diverge from ideal-type models and use elements of distinct systems to create new hybrid forms. Thirdly, the inherited institutions of political embeddedness offer a third archetype model from which firms may borrow elements to develop forms of corporate governance “with Chinese characteristics”.

The empirical model integrates the most crucial elements of each ideal-type system, along with measures of political embeddedness. The research design is inductive, using a set theoretic method to let emerge the dominant configurations that lead to profitability. To allow a comparison between the two institutional settings, private firms and SOEs are analyzed in separate samples. The results show four broad categories of configurations of well performing private firms: market pressure, outsiders’ voice, insider-control and politically embedded. Three broad models emerge in the SOEs sample: external pressure, insider-control and national champions. Generally, the findings suggest that there is a large diversity of configurations in SOEs that can lead to firm performance, while the sample of private firms displays a higher adherence to fewer dominant forms.

The results offer a number of important findings. Firstly, there is substantial heterogeneity of corporate governance forms in China that can equally lead to firm performance. While some configurations lean more towards one ideal-type system or the other, most represent hybrid forms that integrate elements from different models. Secondly, the results confirm that elements from different models can act as functional equivalents to achieve the same objective, such as monitoring managers or mitigating political pressures. Thirdly, successful politically embedded configurations are observed in both samples, although they cover surprisingly few private firms. Still, this suggests that institutions of political embeddedness are able to adapt to the changing and increasingly market-driven environment of listed firms in China. It also shows that the Chinese regime can accommodate a large variety of forms, leaving substantial flexibility for firms to search for specific bundles of practices that fit their needs and constraints. Fourthly, large minority investors and practices of proactive disclosure appear in most configurations for each sample. While these two elements are quasi-necessary conditions that have symmetric effects across all configurations, most

conditions are involved in complex interaction effects. Documenting this causal complexity contributes to reconciling some equivocal results found in previous empirical work.

5.3 Comparison and General Contributions

The two studies display a number of similarities. Firstly, the samples for the empirical analysis are based on the same population of firms. Except for the exclusion of a few industries in chapter three as explained above, both studies include nearly every firm listed with normal A shares on the two mainland China stock exchanges. Secondly, both chapters tackle a research question that relates to corporate governance and includes some measures of the composition and structure of the Board of directors. Thirdly, both papers use set theoretic methods operationalized with fsQCA to outline configurations. Given their many similarities, the two chapters offer a cohesive whole that presents the complexity of the Chinese corporate governance landscape.

Still, the two chapters have a number of differences. Firstly, they have a different empirical focus. While chapter 2 focuses on the conditions leading to the presence and absence of a specific governance problem, chapter 3 looks at the resulting firm performance. Secondly, while both studies rely on inductive reasoning, chapter 2 draws propositions from the literature that aim to guide the empirical analysis. Chapter 3 is entirely exploratory, letting emerge the corporate governance forms observed in China. Thirdly, while the chapters each include two separate analyses, the nature of the comparison differs. Chapter 2 looks at the symmetry of the results by using the exact same sample twice, but with the reversed outcome for the second analysis. Chapter 3 uses the same outcome but divides the population into two separate samples (private firms and SOEs) that are then compared. Fourthly, they have a different conceptual focus. Chapter 2 focuses on the interactions among conditions, emphasizing the occurrence of complementarities and substitutions among the elements of the system rather than characterizing each configuration independently. Chapter 3 offers a thicker discussion of each configuration observed in the solution sets as a distinct prototype for the emerging forms of corporate governance in China.

Apart from the findings and contributions explained in detail in every chapter, the thesis as a whole supports some general ideas that are worth mentioning. In general terms, when making sense of the Chinese experience, the literature imposes a dichotomy between the contractual approach and the common pool resources. For instance, Sachs and Woo (2001) frame this debate as opposing the *experimentalist school* to the *convergence school*. These are supposedly on opposite sides of a so-called transition process. Yet, what is observed does not fit an ideal-type model. Firms creatively recombine elements from different models to create new ones. The case of China shows that firms are able to implement and maintain corporate governance structures even in the context of poorly enforced property rights. This indicates that the importance of formal property rights in North's (1990) tradition that institutions must precede markets may be over-emphasized, at least according to the Chinese experience. Also, the literature often confuses two distinct roles of the state: the state as provider of regulatory framework and formal legislation, and the state as an actively involved market player through ownership and networks. Yet, at the disaggregated level (firm level), the state appears to have enough incentives not to follow its own rule, its own "coherent" regulatory framework. This is partly explained by the deliberate institutional ambiguity (see Ho, 2001), but also by the simple fact that the state is actually composed of various actors with their own roles and agenda at multiple levels of the bureaucracy. There is a need to better decompose the role of the state, and such an exercise is necessarily context-driven. Another dichotomy offered by the literature to reflect on this decomposition is the characterization of formal and informal systems. The literature regards a deviation from the ex-ante contract (ex: corporate governance) as "informal". While this dichotomy may be useful at the system level, it is scarcely informative when disaggregating at the firm level since there is no clear dichotomy. The work contained in this dissertation supports the idea that a configurational approach that accounts for the specificities of the recombination process observed at the firm level is more effective than dichotomies as a conceptual tool to translate the complex reality.

CHAPTER 2 - PRINCIPAL-PRINCIPAL RELATIONSHIPS AT THE CORE OF CORPORATE GOVERNANCE PROBLEMS IN CHINA: A SET THEORETIC ANALYSIS

Abstract: Corporate governance problems in countries with high ownership concentration in listed firms rest in principal to principal rather than on principal-agent relationships. A dominant concern in Asia is the use of related party transactions by controlling shareholders to expropriate cash flow from the firm. In a transition economy like China, the ill-enforced regulatory framework and the heavy participation of the state in the economy add complexity to the issue. This article is the first to use a set theoretic approach (fsQCA) to analyze the interactions among corporate governance conditions that lead to high and low tunneling behavior in 1337 Chinese listed firms in the form of related party loans. The results show substantial asymmetry in terms of complementarities and substitution effects between elements of ownership structure, state control, corporate governance practices and other key demographic factors including firm size and indebtedness. Firstly, a low proportion of shares by the largest shareholder, high indebtedness and small firm size combine to set the incentives and mechanisms for tunneling. Secondly, provided that incentives are in place, a lack of governance practices enables tunneling. In the absence of incentives, governance practices matter little. Thirdly, board independence is found to contribute to tunneling in state-controlled firms and in those that display large minority investors, possibly facilitating collusion at the top of the ownership structure.

Keywords: corporate governance, board of directors, China, principal-principal problems, tunneling, state-owned enterprises, QCA.

JEL Classifications: G32, G34, H82, M14, O53, P31

1 INTRODUCTION

The field of corporate governance has long had a narrow focus on principal-agent relationships between owners and managers (Daily et al., 2003; Rubach & Sebora, 1998; Shleifer & Vishny, 1997), mainly paying attention to the alignment of executive incentives

through compensation packages, the establishment of internal monitoring by optimizing board composition and the nurturing of external control through healthy markets for hostile takeovers (Blair, 1995; Fama & Jensen, 1983; Rajan & Zingales, 1998; Walsh & Seward, 1990). Yet, instead of originating from principal-agent problems, the biggest corporate governance concerns in many countries come from principal to principal relationships (Faccio et al., 2001; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). In markets characterized by high ownership concentration, the disparity of interests between the many owners is more salient. In this sense, it cannot be assumed that shareholders form a homogenous group. The difference to principal agent relations is as follows. While agents, i.e. managers, are controlled by their principals, i.e. owners which have an interest in safeguarding effective allocation of resources and investment into productive activities which promise high future returns, in principal-principal relations one needs to distinguish between insider and outsiders. At the heart of this phenomenon, the collusion of interests between at least one principal and the agents may cause problems, enabling the owner to reap private benefits of control beyond his legitimate cash flow rights. Indeed, the presence of a large controlling shareholder typically involves direct control over high management, effectively ensuring the alignment of incentives between the dominant principal and the agent, which are together characterized as ‘insiders’. The other principals are mostly small investors better characterized as ‘outsiders’ that keep minority shares and expect more moderate yet fair and proportionate financial returns, mostly in the form of dividends. The interaction between these groups of owners determines the allocation of assets and cash flows within the firm. The structure of ownership is therefore paramount to understanding the principal-principal relationship. In other words, modeling principals as one homogenous group or assuming divergent interests between all principals and agents misses the actual decision making and cash flow appropriation.

Conventionally, the relationship between the multiple principals is organized in contracts set to align their interests, including ways to resolve conflicts. The contracts usually cover liabilities, transfers of assets, organizational forms that separate management and ownership and the allocation of residual benefits. Yet, within the contractual relationship, a misalignment remains between the interests of minority investors and the largest shareholder. Because of the discrepancy between its decision making rights and income

rights, the largest shareholder can use his dominant position to appropriate a disproportionate share of the firm's residual returns (Claessens et al., 2000). In other words, the generation of private benefits of control becomes more desirable than the redistribution of cash flows according to income rights when insiders hold nearly full control of the firm (Shleifer & Vishny, 1997). This diversion of cash flow has been referred to as the controlling shareholder expropriation problem (Chen et al., 2011). The most common form of such expropriation is called tunneling (Friedman, Johnson, & Mitton, 2003), which consists of the transfer of assets within a corporate network through loans or sales to other entities controlled by the same owner. Because they involve parties that are connected through ownership ties or possibly by kin, these dealings are referred to as related party transactions. Tunneling has been identified as the greatest corporate governance challenge in Asia generally (Faccio et al., 2001; Johnson et al., 2000; OECD, 2009a, 2011a, 2011b) and in China specifically (Young et al., 2008).

The literature on investor-protection (La Porta et al., 2000) suggests that the safeguard of shareholders' interests rests on contracts supported by laws and regulation. Djankov, La Porta, Lopez-De-Silanes and Shleifer's (2008) anti-self-dealing index is noteworthy to this end. The index assessed for 72 countries as of 2003 the legal framework that underpins private enforcement mechanisms before and after a related party transaction. Its components, divided into ex-ante and ex-post control indicators, reference requirements for disclosure, independent review, derivative lawsuits⁸ and civil liabilities as well as measures of public enforcement, fines and prison terms for contraveners. China appears in the top 10 of countries with the best score for anti-self-dealing regulations. Yet, it scores zero in the public enforcement index (Djankov et al., 2008). This underscores the idea that a formal approach only works in the context of strong legal institutions that enforce binding contracts.

Such contractual and legal measures may therefore not be effective in markets with ill-functioning institutions like China, which carries a socialist heritage where there is no tradition for protecting individual property rights, entitlements and obligations. In this vein, the *experimentalist school* attributes the Chinese successes to competitive SOEs, collectively

⁸ Lawsuit brought by a shareholder on behalf of the firm, often against an insider.

owned township and village enterprises (TVEs) and ambiguous agricultural land property (Sachs & Woo, 2001). From this perspective, the relation to ownership rather resembles a system of jointly owned resources or common property regimes (see common-pool resources, Elinor Ostrom, 1990), inherited from the past where a clan or a local community functioned as collective owner. In this system, resources are owned by the village or county collectively and no clear property rights based on contracts are guaranteed by national legislation. As has been shown in the literature on the ‘commons’, this may create some conflicts of free riding and overgrazing. The over-use of resources by individuals in the short run at the expense of long term availability becomes symptomatic and may lead to underinvestment. In this “non-contractual” context, decision-making power and usage of cash flow is constantly negotiated and recombined among principals (Stark, 2001). In China, this view has been especially dominant during the rise of township and village enterprises (Krug & Hendrischke, 2012), and is still relevant in the ministries that administer a substantial proportion of listed firms and regulate all of them. This heritage has two main consequences. Firstly, the contracts are often not binding. Secondly, firm ownership is still frequently collectively held in the hands of the state. In other words, principal-principal relationships in China are not only about ownership contracts, but also about the involvement of the state and a weak legal system. The study of tunneling and expropriation needs to account for this, especially in the case of state owned enterprises (SOEs). Besides the aforementioned incentives to harvest the private benefits of control, governance in state-owned enterprises may also be tainted by politically driven constraints and incentives that serve the political intentions of the state rather than the commercial interests of the firm. The view taken here is that the Chinese case does not fit any ideal type, that it lies somewhere between the contractualist approach and the heritage of jointly owned resources.

The aim of the present article is to shed light on the conditions driving tunneling behavior in the context of weak private ownership rights. It is not necessary to further investigate whether cash flow is redirected to serve other purposes, such as political aims of cadres or private economic interests of shareholders. It is rather the identification of conditions which set incentives, offer a suitable mechanism, and possible constraints which clarifies the interaction leading to the diversion of cash flow. Specifically, the main research question is the following: under which conditions does the controlling shareholder have the incentive

and the ability to expropriate cash flow from the firm. The model developed here posits that principal-principal problems depend on four types of conditions: ownership structure, state control, corporate governance practices, and financial factors including firm size and leverage. Embedded in this question, because of the recent heritage of jointly owned resources, is the additional objective of assessing whether the conditions producing tunneling in SOEs are different from those in private firms. Finally, this study accounts for the possibility that tunneling may be an asymmetric problem. In other words the conditions that lead to expropriation are not necessarily expected to be the opposite of the conditions that deter it. Do owners face disincentives or lack the appropriate tools for tunneling? Can corporate governance practices help prevent such attempts? Accordingly, two separate analyses are used to assess the conditions under which tunneling behavior is present, and those under which it is absent.

The empirical study uses a set theoretic method (Fiss, 2007, 2011) operationalized in the fsQCA software (Ragin et al., 2006). Such a configurational analysis has been identified as a particularly well suited method to study the causal complexity of corporate governance structures (Filatotchev & Allcock, 2010; Short et al., 2008). Set theory, using Boolean logic, is especially useful in the study of equifinality, which involves multiple causal paths to a single outcome. It also allows analyzing causal asymmetry when specific governance practices are instrumental to both the presence and the absence of an outcome depending on the interaction with other conditions, and whether particular conditions act as functional equivalents involved in neutral permutations in their causal relation to the expropriation problem. The outcome variable that measures the extent of the tunneling problem is based on a measure of related party loans, which represents money that the firm transfers to another related firm through the use of inter-firm loans. The item “other receivables”, disclosed by Chinese listed firms until 2005 in their annual report, contains inter-firm loans and has been identified as a valid measure of related party loans and a good proxy for tunneling (Jiang et al., 2005, 2010). It has been demonstrated that the larger these other receivables are, the larger the share that can be directly traced to a related party or parent company. While using inter-firm loans does not represent malpractice in itself, preferential loans freeze cash flow that could otherwise be put to productive use. In addition, top executives of 10 firms that

had failed to recover such loans to related parties in 2006 were arrested by the authorities (Jiang et al., 2010).

The dataset contains 1337 listed Chinese firms for the year 2005, representing 99% of the population. While the market has evolved since 2005, related party transactions are still considered the biggest corporate governance problem in Asia, including in China (OECD, 2009a). Ironically, the emphasis put on disclosure has also pushed firms to better hide certain transactions, making measures of tunneling increasingly blur. 2005 was therefore chosen because it is the most recent year for which the “other receivables” were disclosed, and because other studies on the same time period and population allow to compare the results of the configuration analysis with the existing empirical literature based on statistical methods. This offers the opportunity to improve existing conceptual building blocks, especially regarding the interactions between the determinants.

The results offer a number of interesting findings. Firstly, a low proportion of shares by the largest shareholder produces a misalignment of interests with those of minority investors and provides incentives for tunneling. High firm indebtedness (leverage) is identified as a key causal condition in most configurations that lead to tunneling, and thus appears to be used as a mechanism to draw monetary resources to be tunneled to related parties. These two conditions, along with small firm size, are involved in a three way interaction in which the presence of only two out of three conditions is sufficient to create the tunneling incentives and mechanisms. These findings are symmetric since a small controlling shareholder, a low leverage and a large firm size are identified as important causal conditions leading to low tunneling. Secondly, the absence of proactive disclosure is a quasi-necessary causal condition to enable tunneling, but it must be complemented by a lack of rigorous audit or a lack of board independence. Only in configurations that rely on large minority investors, it can also be complemented by a low floating ratio. This finding is not symmetric in that, in the absence of tunneling incentives, strong commitment to best corporate governance practices matters very little. Thirdly, provided that there are sufficient incentives for tunneling, board independence is detrimental if combined with state control or large minority shareholders. In such contexts, the results suggest that directorships become a rent generating mechanism that plays an enabling role for collusion towards tunneling behavior.

This research has two main contributions. Firstly, it offers an analysis of the principal-principal problem in the context of weak ownership rights and limited enforceable contracting. The empirical study is helpful to understand under which types of ownership structures, regarding both state ownership and shareholding concentration, a commitment to best practices of corporate governance can effectively align the interests of multiple principals. This is relevant to understand the contractual relationships and governance structures preferred by small investors in any transition economy not only China. Secondly, by identifying the specific configurations that enable tunneling behavior and the ones that inhibit it, the research furthers our understanding of the causal complexity and asymmetry at play in the principal-principal problem. Some equivocal findings from the literature on corporate governance, which are detailed further below, are reconciled by showing that the complementarities and substitution effects through which conditions contribute to the causal relation are not mutually exclusive. This underscores the importance of theorizing corporate governance practices as bundles of interdependent conditions. Such subtle interactions cannot be easily unearthed with traditional statistical methods that rely on marginal and additive effects.

The remainder of this article is divided as follows. Section two offers a literature review of the tunneling problem and the causal conditions and builds propositions used to guide the empirical study. Section three presents the set theoretic method employed in the empirical study. Section four contains and explains the empirical results. Section five discusses the findings and concludes on limitations and implications for future research.

2 CONTROLLING SHAREHOLDER EXPROPRIATION PROBLEM

2.1 Tunneling: Definition and Prevalence in China

According to the OECD (2009b, 2011a, 2011b), the high level of ownership concentration makes Asian markets a fertile ground for tunneling through related party transactions, which now represents the biggest corporate governance challenge in the region. This is in line with previous studies that identified the proportion of shares of the largest shareholder as one of the most important determinant of poor governance in Asia (Claessens et al., 2000; Fan &

Wong, 2002). Similarly, many indices used by consultancy firms to appraise good governance include a measure of ownership dispersion as a key element (see for instance McKinsey & Company, 2002: 16; Standard & Poor's, 2008: 6). While ownership concentration can address the principal-agent problem by reducing the information asymmetry and improving internal monitoring, it can also facilitate the appropriation of private benefits by the controlling owner (Shleifer & Vishny, 1997).

The diversion of cash flow by corporate insiders at the expense of external investors has been given various labels in the literature, including tunneling (Friedman et al., 2003), entrenchment (Claessens et al., 2002), self-dealing (Djankov et al., 2008), principal-principal conflicts (Jiang & Peng, 2011) and controlling-shareholder expropriation (Chen et al., 2011). These terms are used interchangeably in this text. Expropriation can take many forms, including the appointment of unqualified relatives, related party transactions (sales, loans, etc.), family controlled empire building or pyramid control. This can be achieved using direct or indirect means. Tunneling through related party transactions typically consists of a direct transfer of assets to another organization where the controlling shareholder has more income rights (Bertrand, Mehta, & Mullainathan, 2002; Jiang & Peng, 2011). Bae, Kang and Kim (2002) provide an example of indirect tunneling in South Korea, where a group-affiliated firm that conducts an acquisition often falls in value, while other firms in the group, including the parent company, gain value following the transaction. The minority shareholders of the acquirer see their cash flow used unproductively, while the controlling shareholder – the parent company – gains in value.

The attention given recently to this problem especially in China suggests that the balancing act at present requires the refinement of a conceptual framework to analyze controlling shareholder expropriation and the role of the state. China is a fertile ground for large shareholders to appropriate the cash flow of minority investors (Chen et al., 2009; Huyghebaert & Wang, 2012; Jiang et al., 2010; Wang & Xiao, 2011). Wu, Xu and Phan (2011: 108) suggest that the specificity of the institutional environment, with a strong state presence, weak financial protections and “the salience of non-economic stakeholder interests bonded with the economic interests of controlling shareholders” largely account for the prevalence of principal-principal problems in China. Firstly, most firms were privatized and

carry residual state ownership and employment relationships with the Party. This weakens the voice of external shareholders in the internal monitoring mechanisms (Oppen & Schwaag-Serger, 2008). Secondly, Cheung, Rau and Stouraitis (2006) argue that the unreliability of judicial means to enforce shareholder rights limits the use of shareholder activism to protect the legitimate income rights of minority investors. Thirdly, the concentration of ownership (the average has been stable at 40% ownership by the top shareholder over the last 10 years) and the low floating ratio⁹ (the average increased from 42% to 69% between 2005 and 2010) hinder the use of external control mechanisms such as hostile takeovers (Cheung et al., 2006).

To redress the low floating ratio, the state launched in April 2005 the split-share reform that sought to convert the non-tradable shares to be freely negotiated on the secondary market among investors. Prior to the reform, there was a split-share structure in which around two thirds of all shares at issue were non-tradable in the stock exchanges, mostly in the hands of state bodies at various levels. Making every state share of listed SOEs tradable was a big step in the process of privatization of state assets. While most shares are officially tradable since the completion of the reform in 2007, there are still serious limitations on transfers of large block holdings given the lack of market thickness and the industrial policy constraints in state- and SOE-controlled firms. There is also a three year lockup period post-IPO preventing owners from selling their shares. The resulting relatively low proportion of tradable shares has important consequences. Apart from limiting the potential disciplining effect that usually stems from healthy markets for corporate control, the constraints on share transfers dramatically damage the efficiency of the pricing mechanism on the market (Yang, Chi, & Young, 2011). Most importantly, owners of non-tradable shares cannot materialize the value of their asset by selling their shares on the market and are largely indifferent to price fluctuations (Chen et al., 2009). This provides an incentive to appropriate private benefits of control. In this context, given the low proportion of tradable shares supplemented by the high level of ownership concentration, controlling shareholders have the incentives

⁹ The floating ratio represents the proportion of a firm's shares that are tradable on the stock exchange.

and the capacity to initiate self-benefiting related party transactions, effectively tunneling cash flow out of the firm (Cheung et al., 2006).

The next section presents a detailed literature review about the most important factors identified in past theoretical and empirical work that influence the principal-principal problems in large listed firms in transition economies. This review is meant to theoretically ground the guiding propositions put forward in the following section.

2.2 Determinants of tunneling

2.2.1 Ownership structure. This section discusses three factors related to the ownership structure that have an impact on the incidence of tunneling behavior, namely the proportion of equity of the largest shareholder, the presence of large minority shareholders and the proportion of tradable shares (floating ratio). As expressed above, ownership concentration is seen by most studies as an important determinant of tunneling. It is assumed to provide an approximation of the controlling shareholder's incentives to engage in expropriation. However, to be informative, the concepts of ownership and concentration must both be refined. Firstly, it is necessary to decompose the concept of ownership to distinguish the separate effects of decision making rights and income rights. Secondly, it is important to differentiate between ownership concentration among the largest shareholders or in the hands of the single largest shareholder.

Decision making rights and income rights have opposite effects. According to Claessens et al. (2002) and La Porta, Lopez-de-Silanes, Shleifer and Vishny (2002), income rights decrease the incentives for tunneling, while decision making rights are positively related to tunneling. Tunneling would thus be driven by a gap between higher decision making rights and lower income rights. They predict that the higher the income rights of the largest shareholder are, the more his interests are aligned with those of small investors and the less he has incentives to engage in tunneling behavior. Indeed, the cash flow rights of the largest shareholder have been found to be positively related to firm value since higher cash flow rights reduce the tunneling incentives (Claessens et al., 2002; La Porta et al., 2002).

Regarding decision making rights, for the largest shareholder to be able to reap the private benefits of control and have the capacity to engage in tunneling behavior, it is suggested that a certain threshold of decision making rights must be held at the top of the ownership structure. Claessens et al. (2002) report that many studies assume that a threshold as low as 10% may be regarded as yielding effective control over a listed firm. In the Asian context, this is indeed extremely low. In China, the ownership of the largest shareholder averages around 40%. If the 10% ownership threshold is used as a cutoff for effective control, 98% of Chinese listed firms in 2010 would qualify as being effectively controlled by the single largest shareholder (more than 99% in 2005). Even with a 20% threshold, which has been used in past studies on China (Huyghebaert & Wang, 2012), the proportion only falls to 86% of firms in 2010 (92% in 2005). This leaves only a very small minority of Chinese listed firms that could be regarded as being truly widely held compared to international benchmarks. In addition, because it is sometimes the case that a number of large shareholders in a firm belong to the same conglomerate, these numbers even underestimate the real decision making power of most controlling shareholders.

For these reasons, even a low proportion of shares held by the largest shareholder by Chinese standards still represents a very large controlling stake by international standards. Jiang et al. (2010: 11) plainly argue that in the vast majority of Chinese firms, “the largest block holder has effective control, even when holding a relatively low percentage of total shares”. In other words, except for a very small minority of firms, controlling shareholders in China have enough decision making power to implement tunneling mechanisms. The only variable effect remaining, out of the two theorized by La Porta et al. (2002) and Claessens et al. (2002), is that of the income rights, predicting that the higher the percentage of shares owned by the largest shareholder is, the lower is the incentive for tunneling. There is a large gap by default between income rights and control rights and the extent of this gap is nearly entirely driven by the size of the income rights. Therefore, while ownership concentration is the main reason for the prevalence of principal-principal problems, the theory predicts that in the Chinese context the proportion of shares of the largest shareholder is inversely related to tunneling behavior.

Most of the empirical evidence provided in past studies regarding the impact of ownership concentration on shareholder expropriation in China supports this prediction. Jiang et al. (2010) and Huyghebaert and Wang (2012) indeed show that there is a negative relationship between the largest shareholder's income rights and tunneling. Yeh, Shu and Su (2012) also confirm that the alignment of incentives between controlling and minority shareholders measured by the income rights of the former has a negative moderating effect on the positive relation between free cash flow and expropriation. For similar reasons, Lin, Ma and Su (2009) and Qiu and Yao (2009) both find that the largest owner's shareholding has a U-shaped relationship with firm efficiency and firm value, respectively. The initial downward slope might be explained by the few firms that do display ownership dispersion thus limiting the effective control of the largest shareholder, but they interpret the subsequent upward slope as evidence of incentive alignment.

Still, some studies that analyze the same population of Chinese listed during roughly the same time period offer diverging results. Wang and Xiao (2011) and Wu et al. (2011) find a positive relationship between the proportion of shares of the largest shareholder and tunneling behavior. In a similar vein, Chen et al. (2011) find that the relationship between ownership concentration and firm performance has an inverted-U shape. Guthrie, Xiao and Wang (2008) similarly find that joint ownership concentration has a positive relation with profitability. Yet, the "tunneling" interpretation of the link between ownership concentration and performance must be taken with caution. Many factors can influence this link (Sánchez-Ballesta & García-Meca, 2007), such as the type of ownership or the identity of owners (Claessens & Djankov, 1999; Thomsen & Pedersen, 2000), corporate governance practices like board independence (Lefort & Urzúa, 2008) and other factors like investment and leverage (Hu & Izumida, 2008). These factors are discussed in separate sections below and the empirical configurational framework used in the present study provides an avenue to explore their subtle interaction with ownership concentration and the effect on principal-principal problems.

Also, part of this departure from the theoretical prediction might be explained by the fact that two of those studies use measures of concentration that involve multiple shareholders (Chen et al., 2011; Guthrie et al., 2008), which fails to isolate the incentives of the controlling

shareholder. Indeed, some authors study the effect of ownership concentration by looking at the combined ownership of the largest shareholders, usually the five (Chen et al., 2011) or the ten largest (Guthrie et al., 2008). Unless one can provide evidence of collusion, this approach obscures the relation between the level of concentration and the resulting extent of the controlling shareholder's effective control and incentives to conduct expropriation, confounding the very idea of ownership dispersion and concentration. Indeed, the presence of large minority shareholders can have a distinct impact from that of the share ownership of the largest shareholder. Consistent with the idea that ownership dispersion reduces the tunneling problem, the sum of ownership of the second to tenth largest shareholders has been found to increase monitoring on insiders and improve firm performance (Berkman, Cole, & Fu, 2009; Qiu & Yao, 2009). It has also been found to be negatively related to expropriation in the form of related party transactions (Huyghebaert & Wang, 2012). Still, the presence of multiple block holders has produced mixed results in cross-country studies. Faccio et al. (2001) find that minority shareholders that control more than 10% of a firm's stock help to reduce expropriation in Europe, while suggesting the presence of collusion in Asia by intensifying principal-principal problems. They attribute this finding to the poor governance and institutions in Asia's "crony capitalism" and call for more transparency and shareholders' rights.

While this underlines the importance of differentiating the controlling shareholder from other large investors, evidence from past studies is somewhat inconclusive regarding the impact of large minority shareholders. A configurational analysis may help uncovering the conditions under which these principals increase the level of monitoring on insiders and under which conditions they are compelled to collude with the largest shareholder. As mentioned earlier, such an analysis can also allow to assess whether the effect of large minority shareholders on tunneling behavior depends on the level of intra-firm monitoring and on the governance structure as negotiated between minority and controlling shareholders. Still, the main insight about ownership concentration provided by the theoretical literature and the existing empirical work is to accept the proposition that a relatively low proportion of shares by the largest shareholder provides incentives towards tunneling behavior.

Finally, apart from the ownership concentration and the presence of large minority shareholders, an additional condition related to the ownership structure that is an important factor in emerging markets to explain the prevalence of principal-principal problems is the floating ratio (the proportion of tradable shares). Indeed, as explained earlier, the owners of non-tradable stocks that hold a controlling stake cannot materialize any capital gains by trading shares on the market and are therefore incentivized to maximize their private benefits of control (Chen et al., 2009; Yang et al., 2011). The low floating ratio in the Chinese context also hinders the rise of an effective market for corporate control, which would have a disciplining effect on insiders (Cheung et al., 2006). This finds echo in Yuan et al.'s (2009) findings that institutional investors such as pension funds prefer investing in firms with a high proportion of tradable shares, presumably to maximize asset liquidity in a context that is otherwise not characterized by market thickness. Finally, Wang and Xu (2004) use the floating ratio itself as an indicator of overall quality of corporate governance in Chinese listed firms. The extent literature thus suggests that the floating ratio is negatively correlated with tunneling behavior.

2.2.2 State control. Before diving into the specific factors that influence the relation between state ownership and tunneling behavior, it should be noted that government agencies acting as controlling shareholders are also subject to the same incentives and constraints that derive from the size of their stake as discussed in the previous section about ownership concentration. Also, Chen et al. (2011) argue that state ownership in itself cannot be assumed to inherently produce more tunneling, and that controlling shareholders in both private and state owned firms can have incentives to expropriate private benefits at the expense of small shareholders. Still, there are a number of incentives that are particular to government shareholders.

Firstly, the decisions of state officials directly involved in corporate governance can be informed by many other concerns than delivering financial returns to regular shareholders, including the maximization of employment and state revenues (Sappington & Stiglitz, 1987; Shleifer & Vishny, 1994). These political priorities and “non-economic stakeholder interests” can provide the grounds for state agencies to channel resources outside the firm

(Wu et al., 2011: 108) and have been found to negatively affect firm performance (Boardman & Vining, 1989). Secondly, as described earlier, constraints on share trading in SOEs incentivize the diversion of cash flow since capital gains cannot be easily materialized through stock sales (Cheung et al., 2006). Thirdly, the fact that state participation often provides preferential access to loans reduces the need to attract equity capital from external investors, trimming down the incentives to treat small shareholders well (Allen & Shen, 2012).

The inherited collectivistic past of the command economy also enables an undue influence by state officials on managers, weakening the power of outsiders (Opper & Schwaag-Serger, 2008). In this context, even when the state is a minority shareholder, there is the possibility of collusion between private controlling shareholders and rent seeking officials (Shleifer & Vishny, 1994). Many past studies provide empirical evidence supporting the positive effect of various levels of state ownership on tunneling. For example, Wu et al. (2011) find indirect evidence that tunneling is positively correlated with state participation in firm equity while Jian and Wong (2010) further emphasize that state control has the effect of entrenching principal-principal problems. Finally, Huyghebaert and Wang (2012) find that state shareholding in state-controlled firms is positively associated with expropriation.

However, there are also reasons to think that state shareholding can bring benefits. Some have argued that state influence can help curb principal agent problems by exercising complementary control on managers and even reduce controlling shareholder expropriation when the state is not the ultimate owner (Chang & Wong, 2004; Qian, 1995, 1996). From this perspective, when the state is a minority shareholder, its financial interests seem to be aligned with those of external public shareholders. For example, Allen and Shen (2012) observe that the rules on behavior and disclosure by controlling shareholders included in the first Code of Corporate Governance in 2001 were meant primarily to protect state holdings against mismanagement and diversion of cash flow. The claim that state shareholding helps mitigating principal-agent problems is supported by Tian and Estrin (2008), who find a U-shaped relation between state shareholding and firm performance. The idea of a negative relation between state ownership and tunneling is also supported by Lo, Wong and Firth (2010) who report that firms in which the government is the largest shareholder use fewer

price manipulations during related party transactions. Yet, in a study by Wang and Xiao (2011), state control was found to have no significant relation to tunneling.

To resolve the puzzle posed by these mixed results, some authors have suggested a distinction between local and central SOEs. Jiang et al. (2010) find that tunneling is positively related to local state control, but negatively related to central state control. Cheung, Rau and Stouraitis (2010) had also found higher tunneling in the form of manipulated transfer pricing in related party sales in firms controlled by the local state, which they attribute to the higher probability of prosecution for cash flow diversion at the central level. Similarly, Capalbo, Frino, Mollica and Palumbo (2014) find that larger SOEs perform less earnings manipulations, which is consistent with the two preceding findings since central SOEs are nearly five times larger than local ones on average (McMillan & Evans, 2015). Still, beyond the attempts at characterizing different forms of state ownership, many authors observe that much more research is needed to uncover the conditions under which state ownership can be beneficial or detrimental to private investors (Huyghebaert & Wang, 2012).

The empirical investigation presented in this chapter will therefore argue that the influence of state control should be contextualized and embedded in complementary corporate governance practices at the firm level. A subtle analysis of specific configurations of corporate governance and of the relations among many principals will help explaining the conditions driving the causal asymmetry documented in the literature between state ownership and the expropriation problem.

2.2.3 Commitment to best practices of corporate governance When the CSRC released the Chinese code of corporate governance in 2001, officials put the explicit emphasis on the objective of safeguarding the interests of minority investors in listed firms. Most of the provisions of the code and other laws constituting the Chinese corporate governance framework were transplants from textbooks of best practices primarily implemented in Western countries (Yu, 2007), such as the independent director and

fiduciary duty (Clarke, 2006), and more generally the standards promoted by the OECD (2004). These prescriptions are generally inspired from the Anglo-American model of corporate governance. It relies on disclosure as a complementary function of independent auditing (Mangena & Pike, 2005) which, coupled with board independence, a market for corporate control and incentive compensation, represent the basis of market-based mechanisms for effective monitoring by outsiders (Aguilera & Jackson, 2010; Franks & Mayer, 1997; Rediker & Seth, 1995; Walsh & Seward, 1990).

In general terms, past studies provide equivocal results about the impact of firm-level corporate governance practices on tunneling behavior in China. On the one hand, Chen et al. (2011) find that while the expropriation of minority investors' wealth by controlling shareholders in China is salient, it cannot be deterred by board-level governance practices. From this perspective, the usual prescriptions of good governance provide very limited, or no protection to minority shareholders against controlling parties. Chen et al. (2011) argue that agency theory prescriptions are certainly not harmful to small investors in transition economies, but because of the particularities of the institutional environment, the integral transplant of such prescriptions does not seem sufficient to limit the expropriation of small shareholders' cash flow. On the other hand, in the neighboring Taiwanese market (i.e. one with a non-socialist past), good governance practices have generally been found to be effective to constrain the use of related party transactions as a tunneling mechanism (Lo et al., 2010; Yeh et al., 2012). As explained in the following paragraphs, the literature on specific practices also provides equivocal results. The present research surveys three specific interrelated practices that have received particular attention in past studies regarding the principal-principal problem in China, namely information disclosure and rigorous audit which are complementary conditions that enable independent directors to accomplish their monitoring role (Aguilera et al., 2008).

Firstly, board independence is among the most common governance practices prescribed to ensure shareholder's wealth maximization (Daily et al., 2003), since an insider-dominated board is less effective to monitor the CEO (Hayward & Hambrick, 1997). In the Chinese context, the claim that independent directors can effectively increase board vigilance is controversial. According to Peng (2004), the appointment of independent directors serves a

symbolic purpose and does not play an actual role in the corporate governance of Chinese listed firms. Chen et al. (2011) find that board independence has no effect on firm performance. Huyghebaert and Wang (Huyghebaert & Wang, 2012) find that board independence in China is insignificant with regard to related party sales and purchases. This is not entirely at odds with past literature as Kesner, Victor and Lamont (1986) had found the level of board independence to be insignificant in relation with the prevalence of illegal activities among *Fortune 500* companies. Su, Xu and Phan (2008) even suggest that the ineffectiveness of independent directors makes them a liability more than an asset. Chinese independent directors, they argue, fail in their monitoring role because they are either lacking information, colluding with insiders or are appointed on political grounds. Indeed, in firms dominated by one shareholder, especially those controlled by the state, board memberships are used to reward friends of the regime. In other words, the board is seen as a rent-generating tool from which individual members benefit to the detriment of the firm. From this perspective, an independent director is a waste of resources. Yet, some studies provide counterfactuals to this rationale. Liu and Lu (2007) have observed that board independence reduces earnings manipulation surrounding new rights issues. Liu (2006b) also observes that firms with a more independent board, as opposed to an insider-dominated board, display higher performance and generally make decisions that are more favorable to minority investors. These equivocal findings suggest that despite the prescriptions of best corporate governance practices, independent directors may allow for rent-seeking behavior rather than controlling insiders. Still, when considered within a bundle of complementary practices at the firm level, board independence may increase vigilance and deter harmful behavior.

Secondly, proactive disclosure is not a practice that has been traditionally strong in China. Aguilera and Jackson (2003) explain that in countries where the rights of small shareholders are ill-protected, the allocation of decision making rights is more tainted by strategic interests than by legal requirements and that such a system typically mandates little information disclosure. At the firm level, this dynamic has also been observed in family firms that usually rely on the owners' long term commitment and offer much less transparent reporting to outsiders (Dhnadirek & Tang, 2003). Similarly, Liu (2006b) observes that the traditional model of governance in China involves limited financial disclosure, which facilitates decisions that diverge from small shareholder wealth maximization. The fact that related

party loans were readily disclosed prior to 2006 (Jiang et al., 2010) highlights the ineffectiveness of disclosure alone as a monitoring mechanism in absence of legal means to privately enforce the legitimate cash flow rights of shareholders. Still, a survey of investment managers revealed that Chinese institutional investors prefer acquiring stakes in firms that voluntarily disclose more information (Yuan et al., 2009). While disclosure alone may not discipline insiders, it can be complementary with other firm-level practices such as board independence (Cheng & Courtenay, 2006). Also, no study has found a negative effect between disclosure and the treatment of small investors. In essence, this literature suggests that while disclosure is an insufficient monitoring mechanism, it may represent an important condition contributing to prevent tunneling behavior when considered within a bundle of mutually reinforcing conditions.

Thirdly, as outlined above, a rigorous independent audit is also part of the prescribed practices that can contribute to disciplining insiders. Since the present study is primarily interested in the governance structures implemented within the firm, the concept of rigorous audit is conceived through the internal mechanism primarily embodied by the audit committee of the board of directors and the independence of this committee. In one of the few studies looking at internal audit, Xie, Davidson and DaDalt (2003) indeed find that the presence of a financial expert on the audit committee of the board, which was mandated in the US as part of the Sarbanes-Oxley Act and subsequently also required in China, has been found to reduce earnings manipulation in China. A number of other studies have looked at the impact of external auditors. While this does not directly capture the role of internal audit, it provides indications on the relevance and effectiveness of audit practices generally. Also, audit committees are responsible for the appointment of and the relations with external auditors. On the one hand, Liu and Zhou (2005; cited in Liu, 2006b) find that hiring large international accounting firms (the Big 4) to verify the annual report does not improve significantly the quality of reporting compared to companies hiring local accounting firms. They attribute this finding mainly to the desire of the Big 4 to expand their market shares in China, prioritizing client satisfaction over quality disclosure. On the other hand, Chen et al. (2011) find that rigorous auditing, measured as being audited by a top 8 auditor in China, reduces earnings manipulation in private firms, but not in SOEs. Similarly, Huyghebaert and Wang (2012) observe that being audited by a *Big 4* auditing firm is negatively related to

tunneling behavior. Again, while the effectiveness of auditing practices is debated, no study has found a distinct negative impact. Therefore, rigorous audit, much like disclosure, is not in itself an effective deterrent but may within a bundle of complementary conditions contribute to the prevention of tunneling behavior.

2.2.4 Financial factors. Past empirical work on shareholder expropriation points to two additional firm-level factors that can have a decisive impact on the salience of principal-principal problems, either because of a direct causal relation or because of interactions with the conditions reviewed above, namely the ownership structure, state control and corporate governance practices. This section provides a brief discussion about these two factors: firm size and leverage (i.e. firm indebtedness).

Firstly, the existing literature provides equivocal results regarding the effect of firm size on the prevalence of tunneling behavior. Huyghebaert and Wang (2012) observe that firm size has a positive relation to tunneling. Based on comparable results, Yeh et al. (2012) suggest that the fact that firm size is positively related to tunneling is explained by the larger value to be expropriated and the potential role of large firms as transaction hubs of fund transferring in corporate networks. Yet, other studies obtain opposite results. Jiang et al. (2010) and Wang and Xiao (2011) find that firm size is negatively related to tunneling. This conundrum may be explained by another stream of literature, which suggests that the effect of firm size may depend on complementarities with other conditions. For example, Aguilera et al. (2008) suggest that small firms are less concerned with monitoring than with resource accessibility, while larger and more mature firms have structures geared more towards accountability. For instance, independent directors in young firms might be more concerned with resources and strategic decision making aimed at survival, while independent directors in mature firms focus their attention on monitoring. Moreover, board independence in large firms is complementary with information disclosure, which strengthens the communication between external directors and shareholders and strengthens investor confidence (Aguilera et al., 2008). Smaller ventures are typically subject to weaker compulsory disclosure requirements, have fewer external investors, a more concentrated ownership structure, and

fewer independent directors. The virtuous circle observed in large firms is simply not happening. This suggests that board independence, proactive disclosure and other corporate governance practices may provide more discipline on insiders in larger than in smaller firms.

Secondly, high firm indebtedness (high leverage) has consistently been identified in the literature as a factor contributing to tunneling behavior (Jiang et al., 2010; Wang & Xiao, 2011; Yeh et al., 2012). However, leverage has usually been used as a control variable in statistical models and none of the authors cited above provide substantive interpretation explaining this result. A possible explanation is that these firms may have access to more generous bank lending and are less concerned with the need to potentially raise capital from outside investors, reducing the incentive to honor the income rights of minority shareholders. Some firms in China, especially the so-called *national champions* that are handpicked by the state for preferential tax treatment in particular when they venture to invest abroad, indeed benefit from cheap capital from state-owned banks. Local officials are known to enjoy discretionary power in the attribution of loans (Park & Sehn, 2001). Also, Chinese banks are notorious for not monitoring the usage of money once a loan has been granted. In her book *Back-Alley Banking*, Tsai (2002) documents how poorly enforced loan contracts are in China even in the private sector, especially by local banks. The evidence concerning indebtedness, in conjunction with poor banking monitoring, suggests that an underlying expropriation mechanism consists of contracting loans through regular channels of the capital market and subsequently tunneling this capital to related parties. A high leverage is therefore expected to be an important condition contributing to the presence of tunneling behavior.

2.3 Proposition Building, Complementarities and Substitution Effects

The previous section provided a review of the causal conditions that affect principal-principal conflicts. Most of the empirical literature is however based on methods that isolate the effect of each determinant. Theory, on the other hand, is increasingly evolving towards a configurational understanding of corporate governance. Not only is the efficiency of governance structures contingent upon other elements such as the ownership structure and

firm size, but individual practices are often only functioning when part of a bundle of complementary practices. Complementarities can also create asymmetry when a condition produces opposite effects depending on the circumstances. In addition, there may be redundancy if two conditions have an equivalent function, which can result in potential substitution effects.

Misangyi and Acharya (2014) explain that the argument that corporate governance practices are substitutes rests on the idea that they are chosen according to efficiency and costs considerations and that they balance each other to maintain an “equilibrium organization of the firm” (Demsetz, 1983: 384). For instance, to resolve principal-agent problems, more incentive compensation is deemed necessary if the level of monitoring is weaker (Beatty & Zajac, 1994). Similarly, internal monitoring is assumed to be able to palliate to the absence of external discipline provided by an active market for corporate control. Another stream of literature has suggested that corporate governance instead consists of coherent systems of synergistic practices that are best understood as bundles (Aguilera et al., 2008; Rediker & Seth, 1995). This idea of mutually reinforcing conditions has mostly been studied in the international context, comparing how firm level practices adapt to create complementarities with national level institutions (Aguilera et al., 2012). For instance, external control mechanisms and dispersed ownership are only possible in jurisdictions that enforce strong shareholders’ rights. Yet, complementarities do not necessarily entail rigid adherence to an archetype, but can be reduced to two or three practices that create synergies within the bundle (Garcia-Castro et al., 2013). Finally, while substitution and complementarity have typically been opposed as competing views in the literature, recent contributions in this field show that these effects are not mutually exclusive. Indeed, Misangyi and Acharya (2014: 1701) propose that “the effectiveness of the governance bundle involves the simultaneity of substitution and complementarity among the various monitoring mechanisms”. Garcia-Castro et al. (2013: 309) also find empirical evidence supporting the idea that the presence of any two mechanisms that belong to the same coherent bundle is sufficient, as opposed to the whole bundle itself. They argue that this “functional equivalence across bundles of CG practices [...] grants firms agency on which of the practices to implement”.

Beyond these expected complementarities and substitutions between corporate governance practices, interactions may also occur among other firm level conditions. Certain incentives or governance bundles may have an effect only in certain types of firms (Aguilera & Jackson, 2003). As explained above, two conditions are especially relevant regarding the type of firms in the expropriation problem: firm size and private VS state control. For instance, the monitoring role of the board is expected to be more salient in large firms. This contingency is not uniform. For example, the argument that a large share of ownership by the largest shareholder reduces tunneling incentives applies to both large and small firms.

Following these insights, most of the guiding propositions offered below are based on interaction effects that involve the various determinants discussed in the previous section. It should be noted that given its exploratory nature, the investigation is mostly interested in effects that might emerge in an inductive manner and that can contribute to understanding how the ownership structure, corporate governance practices and state control impact tunneling behavior. The propositions are mainly used to guide the empirical analysis and provide an explicit starting point to relate the findings to the existing literature.

The first two propositions concern the incentives and mechanisms that contribute to tunneling behavior. Firstly, a low proportion of shares by the largest shareholder has been identified as a key element contributing to the misalignment of incentives between the many principals (Claessens et al., 2002; La Porta et al., 2002). Secondly, a high leverage stands out as an important mechanism through which firms draw resources to be tunneled (Jiang et al., 2010; Wang & Xiao, 2011; Yeh et al., 2012). Thirdly, a low floating ratio has also been identified as offering an important incentive for controlling shareholders to find alternative ways to obtain cash flow that can hardly materialize through stock value appreciation (Chen et al., 2009; Yang et al., 2011). However, given that state-owned enterprises have strict restrictions on share trading, the impact of the floating ratio is expected to mainly concern private firms. In the case of SOEs, on top of the two first conditions that still apply (a low proportion of shares by the largest shareholder and a high leverage), there may be an additional interaction between state control and firm size. This follows Capalbo et al.'s (2014) finding that smaller SOEs are more prone to manipulate earnings and builds on Jiang

et al.'s (2010) and Cheung et al.'s (2010) finding that local SOEs, which are much smaller (McMillan & Evans, 2015), are more susceptible to engage into tunneling behavior.

Proposition 1a: The largest shareholder in private firms will embark on tunneling if three conditions co-exist: high leverage, low floating ratio, and them holding a relatively low share of equity.

Proposition 1b: In state-controlled firms a relatively low share of equity in the hands of the largest shareholder in combination with high leverage and small firm size leads to tunneling.

In addition to the incentives discussed above, three propositions concern the commitment to best practices in corporate governance. The insights from Chen et al. (2011) suggest that firm-level corporate practices can keep tunneling behavior in check in the event that the controlling shareholder has the incentives and ability to engage in it. An independent board (Liu & Lu, 2007), proactive disclosure (Yuan et al., 2009) and rigorous internal audit (Xie et al., 2003) can contribute to preventing expropriation. The recent literature suggesting that corporate governance practices may be simultaneously complementary and substitutive (Garcia-Castro et al., 2013) warrants the formulation of the following proposition:

Proposition 2: Provided that there are sufficient incentives for tunneling, the lack of at least two out of these three governance mechanisms leads to tunneling behavior: board independence, proactive disclosure, and independent internal auditing.

Yet, this proposition does not encompass the extent of the causal complexity at play in the principal-principal problem. An important factor lies in the role of large minority shareholders, but past literature suggests that this condition may be marked by causal asymmetry. The inclination of such investors in Asia to collude in the diversion of cash flow, as opposed to those in Europe, may trickle from a lack of disclosure (Faccio et al., 2001). Disclosure may therefore be a crucial complementary element with the presence or large minority shareholders if these outsiders are to effectively monitor insiders.

Proposition 3: Provided that there are sufficient incentives for tunneling (see P1) and that there are large minority shareholders, a lack of proactive disclosure is a crucial element contributing to tunneling.

Secondly, past literature is equivocal on the role of independent directors. As suggested in *proposition 2*, a conjunction with other corporate governance practices may instill more vigilance in safeguarding the interests of minority investors (Aguilera et al., 2008). Yet, especially in the Chinese context, boards may be used as rent generating mechanisms to reward friends of the regime (Su et al., 2008). It is expected that such rent seeking motives are mostly salient in state controlled firms, where nominations are used as an instrument to entrench the Party Nomenklatura (Brødsgaard, 2012).

Proposition 4: In state controlled firms, a high proportion of independent directors contributes to tunneling.

In what follows, a configurational analysis on a large sample of Chinese listed firms explores the causal conditions and interactions that emerge in the bundles of conditions that lead to tunneling behavior and those that avert it. The results are discussed in light of the preceding theoretically grounded propositions.

3 EMPIRICAL STUDY: METHODOLOGY

3.1 Data and Sample

The empirical analysis uses firm-level data about 1337 firms listed with standard A-shares on the two Chinese stock exchanges, namely the Shanghai Stock Exchange or the Shenzhen Stock Exchange. Two reasons compel the choice of the year 2005 for the data collection. Firstly, it is the last year and thus the most recent year during which the dependent variable was disclosed by Chinese firms. Secondly, the majority of the empirical studies analyzing tunneling in China, as introduced previously, use data from years ranging between 2002 and 2005, which allows to compare the findings with the existing literature (Chen et al., 2009, 2011; Huyghebaert & Wang, 2012; Jiang et al., 2010; Lin et al., 2009; Wu et al., 2011). During the year 2005, the total population of A-shares denominated firms was 1352. 15 firms were excluded from the sample because of missing data. The final sample therefore covers 99% of the population. The data was collected from two sources, namely the GTA and the Sinofin databases. The measurements for each variable are detailed further below.

3.2 Set Theoretic Method

The field of corporate governance research has been identified as an opportunity for research using configuration analysis. For instance, Short et al. (2008) suggest that looking at the interaction of several characteristics of boards of directors simultaneously could help to solve equivocal issues such as the effect of CEO duality and independent directors on firm performance (Dalton, Daily, Ellstrand, & Johnson, 1998), which remain elusive when their effects are analyzed as competing determinants. Consequently, the set theoretic method (fsQCA) has increasingly been used in corporate governance studies as a way to empirically explore combinations of mechanisms as bundles and complementary factors rather than as isolated additive effects (Bell et al., 2013; Garcia-Castro et al., 2013; Misangyi & Acharya, 2014). It allows to study the interactions among multiple variables simultaneously, while interaction effects in statistical methods are difficult to interpret beyond three-way interactions. For these reasons, fsQCA lends itself to an analysis of the interplay between ownership structure, state/private control and commitment to best practices of corporate governance shaping the controlling shareholder's behavior in terms of tunneling.

The appeal of set theoretic methods lies in the possibility of unraveling the complexity of causal relations. Greckhamer, Misangyi, Elms, and Lacey (2008: 697) explain that “(a) outcomes of interest rarely have any single cause, (b) causes rarely operate in isolation from each other, and (c) a specific causal attribute may have different and even opposite effects depending on context”. Of particular interest, configurational analysis allows for equifinality, causal asymmetry and the identification of core and peripheral causal conditions. Indeed, Fiss (2011: 410) summarizes the unique value of set theoretic methods, explaining that alternative statistical methods “offer only limited insight into the internal causal structure of the different types, the neutral permutations inherent to the types, and the asymmetric causal relationships present across the performance spectrum”. Firstly, equifinality involves a recognition that multiple causal paths can lead to a single outcome. Secondly, the identification of core conditions are useful to categorize different types of cases in which the causal relation to the outcome is supported by possibly interchangeable peripheral conditions (Fiss, 2011). Such second order equifinality may allow the identification of neutral permutations among peripheral conditions in a given configuration

and allow for a more subtle exploration of “intra-type similarities and dissimilarities” (Fiss, 2011: 398). In other words, peripheral conditions are the factors that may vary across configurations that share the same main (core) causal factors. Thirdly, Fiss (2011) and Ragin (2008a) develop the concept of causal asymmetry, conveying that while some causal conditions can explain the presence of an outcome, their opposite might not explain the absence of the same outcome. A different set of conditions might instead be needed. For instance, Fiss (2011) finds that the causal conditions that explain high and very high firm performance are not the same as those that explain low and below average performance.

The operationalization of fsQCA rests the view that the outcome, the causal conditions and the relations between them are analyzed in terms of sets and subsets (Fiss, 2007; Greckhamer, Misangyi, & Fiss, 2013; Ragin, 2000, 2008a). A given case may have membership in more than one set, such as the set of large firms and the set of state-owned firms. The intersection of these sets, including the outcome set, provides evidence about the particular combinations of conditions that can produce the outcome. The set theoretic method allows studying causal mechanisms involving directional, one-way relations, but its value-added is where attributes and sets can be characterized by the concepts of necessity and sufficiency. An attribute is necessary if it is present in all combinations that produce the outcome. An attribute or combination of attributes is sufficient if it produces the outcome by itself. In the present chapter, the first part of the empirical study centers on the identification of configurations of attributes that are sufficient to produce the outcome of tunneling behavior. Following the insights on causal asymmetry, the second part aims to identify the configurations that are sufficient to produce the absence of tunneling.

Originally, fsQCA had been designed as a method that would allow systematic analysis of relatively small samples ($N < 50$). The present study is part of an emerging trend that uses the above-mentioned benefits of set theory on larger samples (Bell et al., 2013; Garcia-Castro et al., 2013; Park & El Sawy, 2013; Whittington, McKee, Goodwin, & Bell, 2013). For instance, Greckhamer et al. (2008) and Misangyi and Acharya (2014) have used QCA analysis on samples of 2841 and 1135 cases respectively. While the procedure remains largely the same as with small-N studies, some differences must be taken into account. Even

before starting the analysis, considerations must be given to the number of conditions included and to the calibration of variables into sets of causal conditions.

Firstly, especially in small N studies, the number of conditions has to be low to avoid that each case becomes its own configuration and to facilitate the search for commonalities. Limiting the number of conditions in large N studies is still important to reduce complexity and facilitate interpretation, but the volume of observations allows for greater flexibility. Generally, Ragin (2008a) suggests that interpretation beyond 8-10 conditions may become elusive. Greckhamer et al. (2013) contend that large-N QCA studies could potentially use up to 12 conditions. In a recent large-N study, Misangyi and Acharya (2014) include 10 explanatory conditions. The inclusion of 9 conditions in the present study is therefore in line with the dominant recommendations and strikes a balance between interpretability and the inclusion of the most important causal conditions identified in the literature.

Secondly, the approach to calibration with large samples might need adaptation from cannons originally designed for small samples. Calibration is the procedure by which variables are transformed into sets. In crisp sets, membership is coded as 1 while non-membership is coded as 0. Fuzzy sets allow for ordinal or interval scale variables to be calibrated along a spectrum between 0, full non-membership, and 1, full membership, where 0.5 is the cross-over point where set membership is at “maximum ambiguity” (Ragin, 2008a: 30). Because not all variance is meaningful (Crilly, 2011), the researcher is expected to use substantive knowledge during calibration to identify meaningful thresholds for full membership, full non-membership and the cross-over point (Fiss, 2011). However, Greckhamer et al. (2013) explain that in large-N studies, researchers are typically less familiar with each case. Using thresholds that are theory driven is preferable, but most recent studies that have used QCA on large samples used data-driven breakpoints to calibrate the variables that exhibit normal distributions. Greckhamer et al. (2008) centered most crossover points at the median. Fiss (2011) and Whittington et al. (2013) also use data driven breakpoints for all the conditions that were not based on Likert scales. This study uses a mix of theory-driven and data-driven calibration procedures depending on the nature of each condition. Five out of nine causal conditions were calibrated according to data-driven thresholds centered at the median. Yet, the fact that the breakpoints used in the data-driven

calibration rests on the distribution of the entire population of Chinese listed firms circumvents problems related to sample-specific biases.

After calibrating the sets of causal conditions and the outcome, the procedure in fsQCA involves three main steps. The first step is the construction of a truth table. The lines of the table list all the possible combinations of causal conditions. For 9 conditions, there are 9^2 lines for a total of 512 combinations. The columns of the table contain the causal conditions, the outcome variable, the frequency of firms that exhibit each combination and the consistency with which those firms are part of the outcome set. Roughly, the consistency represents the proportion of firms in each combination that display the outcome. Not all theoretically possible combinations are observed empirically. This phenomenon is referred to as limited diversity (Ragin, 1987, 2000).

The second step requires the researcher to reduce the table by choosing a minimum frequency level and determine a consistency cutoff. Only those combinations that display the minimum frequency are kept for the analysis. It is recommended that the frequency threshold must be set in order to include around 80% of the sample in the analysis (Greckhamer et al., 2013). In small-N studies the frequency is often set at 1, keeping all empirically observable combinations in the analysis to maximize the diversity and coverage (see for instance Meuer, 2014). In large-N studies, a common rule of thumb suggests that a minimum frequency of 3 shall preserve a reasonably large coverage while maintaining the width of the solution to a manageable level. While full coverage is often expected in small-N studies, a large coverage is desirable but not necessary in large N studies (Greckhamer et al., 2013).

In terms of consistency cutoff, while the recommendations vary from a minimum of .75 (Ragin, 2006) to .95 (Epstein, Duerr, Kenworthy, & Ragin, 2008), most studies consider .8 to be a reasonable threshold. Others suggest looking for a natural break in the data (Schneider, Schulze-Bentrop, & Paunescu, 2010). Determining the minimum frequency and the consistency cutoff has an influence on the coverage and overall consistency of the final solution. A higher frequency increases the coverage but complexifies the solution. A higher consistency cutoff reduces the coverage while increasing the overall consistency. This study uses a process of iteration to reduce the arbitrariness involved in choosing the frequency and

consistency cutoffs. Every possible combination of frequency and consistency cutoffs were tested, incrementally adding 1 unit to frequency and .01 of consistency. The resulting table displays the product of the coverage and overall consistency of each solution. Every solution with 10 or more configurations was eliminated for purposes of interpretability, as well as those displaying an overall consistency lower than .8. The cell with the highest product (overall consistency x overall coverage) set the cutoff points for the analysis.

The third step involves an algorithm that identifies the commonalities of the remaining combinations and reduces the solution into a single Boolean equation of sufficient configurations. The fsQCA software uses the truth table algorithm and produces a range of solutions (Rihoux & Ragin, 2009). The complex solution uses fewer simplifying assumptions, producing exhaustive Boolean equations that are difficult to interpret, while parsimonious solutions take into account all the possible counterfactuals based on hypothetical but empirically absent configurations. The intermediate solution, which uses existing knowledge to discern the plausible counterfactuals to be used as simplifying assumptions (Ragin, 2008a), offers a balanced output in that it provides some level of complexity by including both core and peripheral conditions but in a relatively concise equation (Fiss, 2011; Greckhamer, 2011). These *easy* counterfactuals “refer to situations in which a redundant causal condition is added to a set of causal conditions that by themselves already lead to the outcome in question.” (Fiss, 2011: 403)

The results are presented according to the notation suggested by Ragin and Fiss (2008). In a table, all the causal conditions are listed in the lines while the configurations appear in the columns. In each configuration, the core conditions are indicated with a big dot while peripheral conditions are indicated by a small one. Moreover, the conditions that must be present receive black dots while those that must be absent are displayed as crossed dots. (●: core present, ∅: core absent, •: peripheral present, ∅: peripheral absent).

3.3 Outcome Variable: Inter-Firm Loans as a Measure of Tunneling Behavior

In set theoretic methods, the dependent variable is called the outcome, which in this study is a measure of tunneling behavior. While the problem of tunneling is paramount for investors

and capital markets regulators, its prevalence is very hard to measure. There are two categories of measures: direct and indirect. Direct approaches require the identification of quantified and disclosed expropriation activities. Some of the direct measures that have been used in the past include the volume or price manipulation of related party transactions, inter-firm loans with parent companies and the diverging valuation of two classes of shares (Deangelo & Deangelo, 1985). Some direct measures have looked at the opposite concept of tunneling, using variables such as divestures and dividends to approximate the protection of minority investors. Wu et al. (2011) use such an approach to measure the controlling shareholder expropriation by looking at divestiture activities in firms, which are assumed to be inversely proportional to expropriation. Indirect measures infer the extent of expropriation by looking at the relationship between measures of incentives for expropriation, typically the size of control rights of the largest shareholder, and firm performance, most often ROA or stock return (Chen et al., 2011; Ding, Zhang, & Zhang, 2007; Heugens, van Essen, & van Oosterhout, 2009).

Most tunneling transactions in China take the form of inter-firm loans (Jiang et al., 2005). Such corporate loans represent a particularly interesting measure to trace the extent of tunneling behavior because they do not require additional tests on firm value typically needed with indirect measures (Jiang et al., 2010). Before 2006, these loans were readily observable in the annual reports, not so well hidden under the heading “other receivables” (Jiang et al., 2005). It has been shown that, the higher the other receivables are, the larger is their proportion that can be directly traced to the largest shareholder. This item, listed in the firm's current assets, has been associated with future weakening performance and financial distress (Jiang et al., 2010). Also, in the top 10% of other receivables, firms had a 45% chance of receiving an unclean report by their auditor, which supports the idea that auditing can be effective to improve disclosure but casts doubts on the effectiveness of auditing alone to curb wrongdoing.

For the specific issue of inter-firm loans to related parties, Yeh et al. (2012) ground their model on the internal capital market hypothesis, inspired by transaction cost theory (Williamson, 1964, 1979). Their findings show that such related party transactions are used in a group of firms to coordinate and allocate resources, thereby replacing external sources

of capital and also opening the door to rent seeking behavior. While some related party transactions are dutifully conform to regular business activities (Gordon, Henry, Louwers, & Reed, 2007), Yeh et al. (2012: 758) observe that “a general understanding is that a high level of related party transactions tends to be associated with tunneling practices that go beyond the legal boundaries”.

Consistent with past literature showing that “other receivables” to total assets represent a valid measure of tunneling behavior in the form of inter-firm loans in China (Jiang et al., 2005, 2010; Wang & Xiao, 2011), the present research design adopts the “other receivables” as the outcome variable (i.e. the dependent variable). The calibration of the set memberships was coded as follow: full non-membership was set at the 5th percentile, full membership was set at the 95th percentile and the crossover point was set at the median. Respectively, the values are 0, 34.5% and 2.8%. For the second part of the analysis, meant to identify the configurations that lead to the absence of tunneling, the outcome variable used is the reversed set: one minus tunneling. In order to facilitate interpretation, the same percentiles are used for the causal conditions whose calibration is also data-driven.

3.4 Causal Conditions

Large controlling shareholder. The proportion of shares of the largest shareholder is the most used measure of ownership concentration (Huyghebaert & Wang, 2012; Jiang et al., 2010; Lin et al., 2009; Qiu & Yao, 2009; Wang & Xiao, 2011; Wu et al., 2011; Yeh et al., 2012). The full non-membership, crossover point and full membership are again calibrated according to the 5th, 50th and 95th percentiles. The values are 17.6%, 37.8% and 68%. Since the theoretical prediction is that a *large controlling shareholder* contributes to the absence of tunneling, these thresholds are consistent with results from past studies. Jiang et al. (2010) found that tunneling is highest when the largest block holder owns less than 30% of total shares, which falls comfortably below the chosen crossover point of 37.8%. Chen et al. (2011) found that the proportion of shares held by the largest shareholder is positively correlated with firm performance until it reaches a threshold of 48%, which falls well above the crossover point.

Large minority. This variable replicates previous studies that use the sum proportion of shares of the second to tenth largest shareholders as a measure of the presence of large minority shareholders (Berkman et al., 2009; Faccio et al., 2001; Huyghebaert & Wang, 2012; Qiu & Yao, 2009). The 5th, 50th and 95th percentiles were respectively 1.7%, 18.8% and 44.3%. The presence of this condition together with a *large controlling shareholder* indicates that the firm has a very high ownership concentration among the ten largest shareholders.

Float. The floating ratio is the proportion of shares that are negotiable on the stock exchange. The 5th, 50th and 95th percentiles were respectively 25%, 39.6% and 63.5%.

Independent board. Board independence is measured as the proportion of independent directors on the board of directors. According to the *Guiding Opinion on the Establishment of the Independent Directors' System by Listed Companies* issued by the China Securities Regulatory Commission (CSRC) in 2001, independent directors cannot include any direct family member of anyone employed by or holding over 1% of the shares of the firm or of a subsidiary. The Opinion of the CSRC mandates that at least a third of the board must be independent as a minimum threshold. Following this, firms that display a proportion of independent directors lower than 33.3% are coded as 0. Those that barely comply with the 33.3% rule are coded as .25. Firms that display more than the mandated threshold of 33.3 % receive .51, meaning that they are slightly in the set. Following international best practices, including the rules of the NYSE and the conclusions from the Cadbury report in the UK as well as similar provisions in other countries (Australia, Brazil, Finland, etc.) which recommend that at least half of the board be independent, firms with at least 50% independent directors are coded as fully in (1). To complete the incremental scale, boards with at least 40% independent directors but less than 50% are coded as .75. Following this scale, the term “independent board” should be understood as boards consisting of more than a third of independent directors.

Proactive disclosure. There is no single best systematic measure of disclosure used in the literature, but the timeliness of release of the annual report has been shown to be a sensitive element of disclosure in listed firms (Haw, Qi, & Wu, 2000; Haw, Park, Qi, & Wu, 2006; McGee & Yuan, 2012; Park, Song, Yang, Hossain, & Koo, 2013). Following this

insight, the delay between year-end and the date of release of the annual report is used as a proxy for proactive disclosure. The scale is anchored according to the three reporting deadlines mandated by the Securities and Exchange Commission in the US for filing the 10-k form, which is a standardized version of the financial statements handed to the authorities: 60 days, 75 days and 90 days. While these forms are different in kind from full fledged corporate annual reports and despite the fact that the three deadlines are originally meant to apply to firms of different sizes, these dates are used as indications of proactive disclosure, which should intrinsically go above and beyond mere compliance. The CSRC in China indeed mandates a maximum deadline of 120 days for all listed firms. Consequently, a delay of 60 days or less between year-end and release was coded as fully in (1). 75 days or less was coded as in (.67). 90 days or less was coded as out (.33). More than 90 days was coded as fully out (0).

Independent audit. Two distinct elements combine to construct a measure of independent internal audit. Firstly, to be included in the set, firms must have set up an audit committee in the board of directors. Audit committees are involved in the preparation of annual reports, have access to financial officers, are responsible for recommending external auditors and have privileged access to the auditors. The presence of audit committees is generally expected to improve the overall audit quality (Stewart & Munro, 2007). Secondly, audit committees in China are supposed to include a majority of independent directors, preferably including the chairman of the committee. Moreover, it is strongly advised that an independent director with an accounting title sit on the committee. Ample literature discusses the benefits of independent audit committees. Such independence has been found to reduce earnings manipulation (Klein, 2002), instances of fraud (Abbott, Park, & Parker, 2000) and to enhance firm value (Chan & Li, 2008). While the composition of the audit committee is disclosed in the annual reports, including which members are independent directors, additional information was used to validate their independence. To be included in the set, the disclosed working address of the independent director with an accounting title must be different from the address of the firm. This resulted in a binary causal condition. Firms with an audit committee on the board in which the independent director with an accounting title has a different address than that of the firm were coded as 1. All other firms were coded as 0.

High leverage. Consistent with previous studies, leverage was measured as a ratio of total liabilities to total assets (Jiang et al., 2010; Wang & Xiao, 2011; Yeh et al., 2012). However, to account for the considerable variance in leverage across industries, an adjusted measure subtracts the leverage from the industry average, using the first order CSCR classification and second order classification in the case of manufacturing firms. This procedure is often used in the literature (Acharya, Amihud, & Litov, 2011; Berger & Ofek, 1995; Billett & Xue, 2007), including in studies of Chinese firms (Berkman, Nguyen, & Zou, 2011; Cheung, Jing, Lu, Rau, & Stouraitis, 2009). The 5th, 50th and 95th percentiles were respectively -32.5%, 0.2% and 42%.

Large firm. In line with many past studies, total assets are used as a measure of firm size (Chen et al., 2009, 2011; Liu & Lu, 2007; Yeh et al., 2012). The 5th, 50th and 95th percentiles were respectively 345 million Yuan, 1,518 million Yuan and 9,325 million Yuan. With such a calibration, the absence of *large firm* can also be interpreted as the presence of relatively small firms.

State control (SOE). This causal condition is coded as a simple binary variable. Firms ultimately controlled by a state agency at any level of government, as disclosed by the annual report, are coded as 1. Other firms are coded as 0. Considering the condition of *state control* in conjunction with *large controlling shareholder* provides an indication on the shareholding size of the state in SOEs.

3.5 Descriptive statistics

Table 1 below provides the descriptive statistics for the outcome variable and the nine causal conditions. It provides the mean, the standard deviation, the minimum and the maximum for each variable. The variables SOE and independent audit are binary, so only the mean is reported. Also, three variables (other receivables, leverage and size) contained outliers that skewed the statistics. Extreme values do not affect the QCA analysis like in statistical methods because of the calibration process which puts emphasis on relevant variation and suppresses the irrelevant variation beyond the thresholds of full-membership and full non-

membership. Still, such extreme scores have a great impact on the average and standard deviations reported here. To make the following statistics more informative, the top and bottom 1% were removed from these three variables. The procedure of winsorizing extreme scores is common in statistical methods, including in studies on corporate governance and tunneling problems (see for instance Jiang et al., 2010; Wang & Xiao, 2011). To provide a better demographic picture of the population, table 2 offers data on the geographic and industry distribution. Most listed firms in China are located in Eastern provinces and the South Central region. Guangdong, Shanghai and Beijing alone account for 33% of the population. Also, most firms operate in high-value manufacturing industries, predominantly in machinery and petrochemicals. Finally, the average firm age is 10.09 years, with a standard deviation of 3.91 years, a minimum of 2 years and a maximum of 26 years.

Table 1. Descriptive statistics of tunneling variable and causal conditions

	Mean	Std. Dev.	Min	Max
Net other receivables (%)	7.27%	12.32%	0.04%	98.75%
Share of largest shareholder (%)	40.47%	16.16%	4.24%	84.98%
Share of 2nd to 10th shareholders (%)	20.05%	13.99%	0.50%	63.50%
Floating ratio (%)	41.59%	12.18%	8.68%	100.00%
Proportion of independents on BOD (%)	34.80%	4.62%	8.33%	60.00%
Days to release of annual report	91.15	24.12	19	243
Independent audit	36.05%			
Financial leverage (%)	54.29%	25.97%	7.78%	265.36%
Size (mn RMB)	2639.6	3332.2	147.9	30041.0
SOE	65.30%			

Table 2. Provinces and industry distribution

Region	Province	%	Grouping	Industry	%
Eastern China (37.55%)	Anhui	3.29%	Resources and low- value manufacturing (24.68%)	Agriculture, forestry and fishery	2.77%
	Fujian	3.14%		Mining	1.65%
	Jiangsu	6.66%		Food & Beverages	4.04%
	Jiangxi	1.72%		Textiles & Apparel	4.56%
	Shandong	5.53%		Timber & Furnishings	0.30%
	Shanghai	10.77%		Paper & Printing	2.02%
	Zhejiang	6.43%		Metals	9.35%
Northern China (15.11%)	Beijing	8.08%	High-value manufacturing (38.15%)	Petrochemicals	10.99%
	Hebei	2.39%		Electronics	3.52%
	Inner Mongolia	1.27%		Machinery	15.71%
	Shanxi	1.80%		Pharmaceuticals	6.66%
	Tianjin	1.57%		Other manufacturing	1.27%
North- eastern China (7.18%)	Heilongjiang	1.80%	Services (31.64%)	Utilities	4.49%
	Jilin	2.17%		Construction	2.02%
	Liaoning	3.22%		Transportation	4.19%
Northwestern China (6.28%)	Gansu	1.12%		Information technology	6.13%
	Ningxia	0.75%		Retail and wholesale	6.73%
	Qinghai	0.52%		Finance and insurance	0.22%
	Shaanxi	1.94%		Real estate	4.26%
	Xinjiang	1.94%		Social services	2.84%
South Central China (24.08%)	Guangdong	11.22%		News and media	0.75%
	Guangxi	1.50%	Conglomerates		5.53%
	Hainan	1.35%			
	Henan	2.47%			
	Hubei	4.11%			
	Hunan	3.44%			
Southwestern China (9.80%)	Chongqing	2.17%			
	Guizhou	1.20%			
	Sichuan	4.49%			
	Tibet	0.37%			
	Yunnan	1.57%			

4 RESULTS

4.1 Outcome Tunneling: Operationalization and Solution Output

The analysis is structured in two parts. The first part involves an analysis of the causal conditions that lead to high tunneling. The subsequent section (4.2) involves an analysis of the causal conditions that lead to low tunneling. The outcome variable in section 4.2 is therefore the reverse of the one used in this first section. Complementing the tunneling analysis with its mirror image allows to assess whether symmetry is observed between the causal conditions that lead to tunneling and those that lead to low or absent tunneling. The present section uses the fsQCA software to find the configurations involving nine causal conditions that combine to produce tunneling behavior in the form of inter-firm loans in 1337 Chinese listed firms. After constructing the truth table listing every theoretically possible combination of causal conditions, the first tasks were to exclude a number of combinations based on frequency and consistency thresholds and to input the simplifying assumptions used to produce the intermediate solution. In order to allow for complexity and asymmetry to emerge in the solution, the only assumptions included were those strongly supported by the literature, namely that a high leverage should be “present” and that proactive disclosure, independent audit and float should be “absent”. The remaining conditions (large controlling shareholder, large minority, independent board, large firm and state control) were left as “present or absent” in the simplifying assumptions given the equivocal findings in the literature.

Based on these assumptions, table 3 presents the results of the process of iteration used to find the frequency and consistency thresholds that would maximize the intermediate solution’s overall coverage and consistency. The table reports results for frequencies of 2 and 5 for purposes of comparison even if the selection criteria command the exclusion of these thresholds (2 being lower than the recommended threshold of 3, and 5 leaving an insufficient proportion of cases with 63%). Other thresholds that do not meet the selection criteria are marked with an X. Among the six solutions that match the selection criteria, the solution with the highest resulting factor of overall consistency and coverage is that using a frequency of 4 and a minimum consistency threshold of 0.84. Although solutions involving

frequencies of 2 and 5 were excluded on methodological grounds, their factors were still lower than the selected solution.

Table 3. Frequency and consistency thresholds (outcome: tunneling)

Frequency threshold	Consistency threshold						
	0.82	0.83	0.84	0.85	0.86	0.87	0.88
2	X	X	X	X	0.314	0.202	X
3	X	X	X	0.363	0.275	0.151	X
4	X	X	0.386	0.343	0.266	X	X
5	X	0.373	0.372	0.235	X	X	X

The solution table draws from two of the three resulting solutions from the output in fsQCA. The parsimonious solution, which uses a maximum of counterfactuals, is used to outline the core conditions in each configuration. The Boolean equation¹⁰ resulting in the parsimonious solution reads as follow:

$$\begin{aligned}
 \textit{Tunneling} = & \sim\textit{Minority} * \sim\textit{Audit} * \sim\textit{SOE} + \\
 & \sim\textit{Large controlling shareholder} * \sim\textit{Float} * \textit{Independent board} * \textit{Leverage} + \\
 & \sim\textit{Large controlling shareholder} * \sim\textit{Minority} * \textit{Independent board} * \textit{Leverage} + \\
 & \textit{Independent board} * \textit{Audit} * \sim\textit{Large firm} * \textit{SOE} + \\
 & \sim\textit{Float} * \sim\textit{Disclosure} * \sim\textit{Audit} * \textit{Leverage} * \sim\textit{SOE} + \\
 & \sim\textit{Large controlling shareholder} * \textit{Float} * \sim\textit{Disclosure} * \textit{Leverage} * \sim\textit{Large firm} \\
 & + \\
 & \textit{Independent board} * \sim\textit{Audit} * \textit{Leverage} * \sim\textit{SOE}
 \end{aligned}$$

The parsimonious solution is also displayed within the intermediate solution table as the large dots. The full intermediate solution is shown in table 4 and contains a total of nine configurations. Two couples of two configurations (2a/2b and 5a/5b) are variations that stem from the same group of core conditions as observed in the parsimonious solution. The overall solution consistency is 0.819, which is comparable to that of other large N set theoretic

¹⁰ Symbols are read as follow: ~ stands for logical “absent”, * stands for logical “and”, + stands for logical “or”.

studies. Fiss (2011) reported consistencies between 0.8 and 0.81, while Misangyi and Acharya’s (2014) solutions were between 0.82 and 0.86. The overall coverage is 0.471, which advantageously compares to Fiss’ (2011) range of 0.27 to 0.36 and Misangyi and Acharya’s (2014) range of 0.04 to 0.16. The four main findings derived from the intermediate solution are discussed below. Interpreting a complex set theoretic output can be daunting for the inexperienced reader. Therefore, tables presenting subsets of the solution accompany the discussion of the results to provide more visually intuitive support for the argument. As opposed to many QCA studies, the detailed presentation of the findings is not organized according to each configuration individually. Instead, the text is organized according to the main issues related to the interactions among causal conditions, mainly focusing on complementarities and substitution effects.

Table 4. Solutions for tunneling

	1	2a	2b	3	4	5a	5b	6	7
Large controlling shareholder	∅	∅	∅	∅	∅	∅		∅	∅
Large minority	•	•	•	•	∅	∅	∅		
Float		∅	∅					∅	●
Board independence	●	●	●	●	●	∅	∅	∅	∅
Proactive disclosure	∅	∅	∅	∅	∅	∅	∅	∅	∅
Independent audit	∅			●	∅	∅	∅	∅	
High leverage	●	●	●		●		•	●	●
Large firm		∅		∅	•		∅		∅
State control	∅		•	●	•	∅	∅	∅	
Consistency	85.5%	85.8%	83.3%	82.7%	82.9%	86.0%	88.5%	84.8%	85.6%
Raw coverage	9.2%	25.0%	14.8%	6.7%	9.1%	9.4%	8.5%	8.6%	35.2%
Unique coverage	0.6%	0.9%	0.6%	0.9%	0.8%	1.5%	0.8%	1.0%	9.0%

Overall solution consistency: 81.9%					Overall solution coverage: 47.1%				

4.2 Outcome Tunneling: Findings

Tunneling incentives and mechanism. The first finding concerns the tunneling incentives and mechanisms embodied in the conditions of large controlling shareholder, high leverage and large firm (see table 5 for the solution subset). To begin with, the solution

strongly supports the claim that *the effect of the proportion of shares of the largest shareholder lies in the cash flow rights (the incentives effect) rather than the control rights*¹¹, confirming that in China even relatively small control rights are sufficient to have a control stake. Because smaller cash flow rights result in a misalignment of incentives between the controlling shareholder and minority investors, *relatively small ownership by the largest shareholder generate incentives for tunneling*. It is a quasi-necessary condition, appearing in eight out of nine configurations in the solution, but it is not in itself a sufficient condition for tunneling. Additionally, a *dominant mechanism to draw resources to be tunneled appears to be high firm indebtedness*, signaled by the high leverage. A high leverage is indeed a present condition in seven out of nine configurations. This does not make it a necessary condition but it lends strong support to the contention that firms use regular channels in the banking sector to borrow money, providing resources that are then tunneled to related parties through inter-firm loans.

Table 5. Tunneling incentives and mechanism

	1	2a	2b	3	4	5a	5b	6	7
Large controlling shareholder	∅	∅	∅	∅	∅	∅		∅	∅
High leverage	●	●	●		●		•	●	●
Large firm		∅		∅	•		∅		∅

An additional condition appears to complement the incentive stemming from relatively low cash flow rights and the use of firm indebtedness: relatively small firms. The effect of small firm size is not completely homogeneous since configuration 4 requires a large firm (this exception is discussed below). Yet, the absence of large firms is a causal element in four configurations. This suggests that *minority investors in small firms are more vulnerable to the controlling shareholder expropriation problem*. All in all, the solution shows that every configuration except one exhibits *at least two of the three conditions: absence of large controlling shareholder, presence of high leverage and absence of large firm* (see table 5: there are at least two grey areas in all but one column). This partly complementary and partly substitutive effect is further supported by the neutral permutation observed in configurations

¹¹ The italicized text is used to emphasize the main findings.

5a and 5b. Specifically, these two configurations display the same core conditions, but differ slightly in the peripheral conditions: 5a must have a small controlling shareholder, while 5b must instead be a small firm with a high leverage. In this context, the absence of a large controlling shareholder is a functional equivalent to a small indebted firm.

Although these findings are generally in line with propositions P1a and P1b, three elements offer some degree of departure from the predictions based on the extant theory. Firstly, while firm size was expected to play a role mainly in SOEs (P1b), the effect of small firms also applies to private firms. Secondly, while the propositions advanced that these conditions are complementary, they also exhibit a partly substitutive effect, much like that theorized in proposition P2 for corporate governance practices. Thirdly, a low floating ratio, which was put forward as a tunneling incentive in proposition P1a, does not contribute as a substitute in the three-way interaction among the three other elements: small controlling shareholder, high leverage and small firm.

Dispersed ownership. This section analyses the two exceptions from the findings discussed above. Indeed, two configurations diverge with part of the preceding argument about incentives and mechanisms in two distinct ways. Firstly, configuration 5a is the only one that does not present at least two of the three conditions discussed above (small controlling shareholder, high leverage and small firm). Secondly, configuration 4 is the only one in the solution that includes the condition large firms. These two odd configurations share the unique feature that they have dispersed ownership, displaying both absent large controlling shareholder and absent large minority. By Chinese standards, the 10 largest owners of these firms have relatively small shareholding. Configuration 5a shows that *for a private firm with dispersed ownership to engage in tunneling, all three conditions related to corporate governance practices must be absent.* Configuration 4 shows that *the propensity for tunneling in SOEs with dispersed ownership rather rests on indebtedness and firm size.* It is worth noting that in the three configurations that require absent large minority, including the two with dispersed ownership, the floating ratio has no causal relation to the outcome. In other words, this suggests that *the proportion of tradable shares does not matter where minority investors are relatively small.* In addition, these three configurations all rely on insider-controlled audit.

Table 6. Absence of governance practices

	1	2a	2b	3	4	5a	5b	6	7
Large minority	•	•	•	•	∅	∅	∅		
Float		∅	∅					∅	•
Board independence	•	•	•	•	•	∅	∅	∅	∅
Proactive disclosure	∅	∅	∅	∅	∅	∅	∅	∅	∅
Independent audit	∅			•	∅	∅	∅	∅	

Absence of corporate governance practices. The absence of commitment to best corporate governance practices plays an important role leading to tunneling behavior (see table 6 for the solution subset). The way in which this effect unfolds depends on the presence of large minority shareholders. In the five configurations that do not include the presence of *large minority* (on the right side of table 6), *at least two out of three corporate governance practices (disclosure, audit, independent board) must be absent*. The four configurations involving large minority shareholders ask for a closer look (left side of table 6). As table 6 indicates, a low floating ratio becomes an important corporate governance indicator in the presence of large minority shareholders, which supports Wang and Xu’s (2004) idea that the floating ratio might be considered as a valid proxy for good corporate governance. Specifically, configurations 2a and 2b seem to support a *substitutive effect between the absence of float and the absence of independent audit in firms with large minority investors*. Including float among the governance indicators increases the number of configurations with at least two missing governance indicators at eight out of nine.

These findings are largely in line with proposition P2, namely that provided that there are tunneling incentives, the absence of governance practices plays an enabling role towards tunneling. Yet, in the results, this relation is bounded to configurations that do not rely on large minority shareholders. In this later case, a low floating ratio becomes a valid substitute explaining the lack of control on insiders. It should also be noted that the *absence of disclosure is a contributing element in every configuration* within the solution. The absence of proactive disclosure is not by itself a sufficient condition leading to tunneling behavior, but it can be considered as a quasi-necessary one. This is fully in line with proposition P3. However, the effect of absent disclosure is not limited to configurations that include large

minority shareholders as put forward in the theory, but rather applies to all firms in the solution.

Table 7. Asymmetry and board independence

	1	2a	2b	3	4	5a	5b	6	7
Large minority	•	•	•	•	∅	∅	∅		
Board independence	●	●	●	●	●	∅	∅	∅	∅
State control	∅		•	●	•	∅	∅	∅	

Board independence and asymmetric effects. The three conditions that particularly display asymmetric effects also present complementarities. Table 7 (solution subset from table 4) shows in configurations 1 to 3 that the presence of large minority shareholders is always accompanied by a large proportion of independent directors on the board. This result is particularly striking. The literature (see Faccio et al., 2001) had suggested that, as opposed to Europe where they contribute to internal monitoring, large minority investors in Asia may collude with the controlling shareholder and thus allow for tunneling behavior, possibly in an attempt to obtain private benefits along with the insiders. Yet, many empirical studies have provided rather equivocal results. The evidence supplied here suggests that the presence of an important group of *independent directors, which are supposedly the watchdogs of small shareholders’ interests, has an enabling effect for collusion when the proportion of shares of minority investors is relatively high.* A similar effect seems to play a role in state-owned enterprises. Table 7 indeed shows that every configuration involving state control as a causal condition also relies on board independence. *The nomination of selected outsiders to the board in SOEs thus appears to play an enabling role for state agents to tunnel cash flow out of the firms.* While the main object of the present study is to document the conditions under which tunneling takes place rather than why and where cash flow is channeled, this seems to support the contention that directorships in SOEs are awarded as a rent generation mechanism within the Party Nomenklatura (Brødsgaard, 2012), in which performance criteria are driven by political goals rather than the maximization of normal shareholders’ wealth. Taken together, these observations show that independent directors, when supported by strong outsider groups like large minority shareholders in private firms or by the government agents who nominated them in SOEs, actively contribute to tunneling

behavior. These findings are in line with proposition P4, with the additional observation that the rent generating role of independent directors also applies with the presence of large minority shareholders.

To summarize, the most striking findings from this analysis are threefold. Firstly, a combination of at least two out of these three conditions is found in firms where the controlling shareholder engages in tunneling behavior: small proportion of shares by the largest shareholder, high financial leverage and small firm size. Secondly, the lack of effective corporate governance practices (board independence, rigorous internal audit and, most importantly, proactive disclosure) plays an enabling role towards tunneling in firms that do not rely on large minority investors or on state control. Thirdly, independent directors seem to assist collusion to facilitate tunneling in firms controlled by the state and in those with large minority shareholders, which is an interesting limitation to the governance best practices of board member independence.

4.3 Outcome No Tunneling: Operationalization and Solution Output

The second part of the empirical analysis applies the same methodology but uses the reverse of the outcome: absent tunneling (*~Tunneling*). The calibration of every variable remains the same, except for the outcome variable which is calculated as one minus the set membership of tunneling. The sample remains the same with 1337 Chinese listed firms. In order to facilitate the comparison between the two empirical sections, the simplifying assumptions drawn for the intermediate solution are simply the reverse of those used in the first part. *Leverage* was marked as “absent”, while *proactive disclosure*, *independent audit* and *float* were marked as “present”. The remaining five conditions were left as “present or absent”. Again, an iteration process was used to identify the frequency and consistency thresholds in the truth table in order to maximize the solution’s overall coverage and consistency. Since the number of causal conditions also remains the same, the choice of frequency was limited between 3 and 4 to avoid excluding too many cases. Table 8 shows that the only combination fitting the selection criteria uses a frequency of 4 and a minimum consistency threshold of 0.97. It also reports iteration results for a frequency of 5 for purposes of comparison.

Table 8. Frequency and consistency thresholds (outcome: no tunneling)

Frequency threshold	Consistency threshold			
	0.95	0.96	0.97	0.98
3	X	X	X	X
4	X	X	0.35	X
5	X	0.338	0.288	X

The parsimonious solution resulting from the process of logical reduction contains 8 configurations. Its Boolean equation is shown below. This solution is also embedded in the full intermediate solution presented in table 9. The solution contains nine configurations, among which two (3a/3b) are separate subsets of the same configuration of core conditions. The overall consistency is 0.950 and the overall coverage is 0.368. These measures of fit are above those of comparable studies (Fiss, 2011; Misangyi & Acharya, 2014). One of the reasons for the lower overall coverage observed here compared with that of the first analysis is the lack of solutions involving private firms. Eight out of nine configurations concern SOEs. This entails that there is a much wider diversity of configurations for private firms to achieve the outcome of absent tunneling. Fiss (2011) encountered a similar situation in his study of firm performance when he studied the reversed outcome, concluding that there are few ways to achieve high performance while there are many ways to obtain low performance. For the present study, this means that there are few ways for owners of private firms to achieve high tunneling, there are many ways to achieve low tunneling. Hence, because the interpretation of the results must be very cautious regarding private firms due to its low coverage, configuration 8 (the one with absent SOE) will be discussed separately. Therefore, one remark worth emphasizing is that unless otherwise mentioned, the findings presented below concern only SOEs. Again, tables presenting subsets of the solution are used to provide visually intuitive support to the argument.

$$\begin{aligned}
 \sim\text{Tunneling} = & \text{Float} * \text{Disclosure} * \text{Large firm} + \\
 & \text{Large controlling shareholder} * \sim\text{Float} * \text{Disclosure} * \sim\text{Leverage} + \\
 & \text{Large controlling shareholder} * \text{Large minority} * \sim\text{Leverage} * \text{Large firm} + \\
 & \text{Large controlling shareholder} * \text{Float} * \text{Independent board} * \sim\text{Audit} * \sim\text{Leverage} * \text{Large} \\
 & \text{firm} + \\
 & \text{Disclosure} * \text{Large firm} * \sim\text{SOE} +
 \end{aligned}$$

*Large controlling shareholder *Disclosure*Audit +*
*Large minority*Independent board*~Leverage*Large firm +*
*Large controlling shareholder *~Float*~Independent board*Audit*~Leverage*Large*
firm

Table 9. Solutions for absent tunneling

	1	2	3a	3b	4	5	6	7	8
Large controlling shareholder	●	•	●	●	●	●	•	●	∅
Large minority	∅	∅	∅				●	●	•
Float		●	∅	∅	∅	●	•		
Board independence	∅			∅	∅	●	●	∅	∅
Proactive disclosure	●	●	●	●					●
Independent audit	●				●	∅	●		
High leverage			∅	∅	∅	∅	∅	∅	
Large firm		●	∅	∅	●	●	●	●	●
State control	•	•	•	•	•	•	•	•	∅
Consistency	92.2%	97.5%	96.5%	96.5%	97.1%	97.5%	97.3%	97.7%	96.7%
Raw coverage	6.3%	11.5%	11.5%	12.5%	8.7%	10.1%	4.7%	16.9%	5.6%
Unique coverage	0.8%	1.2%	0.3%	0.6%	1.8%	1.7%	0.7%	3.0%	5.6%
Overall solution consistency: 95.0%					Overall solution coverage: 36.8%				

4.4 Outcome No Tunneling: Findings

Tunneling incentives and mechanism. The most striking finding from this solution is the symmetry with the tunneling incentives and mechanisms observed in the previous analysis (section 4.2 on tunneling). Every configuration includes a large controlling shareholder, which is the reverse of the tunneling solution. Whether a firm embarks on tunneling or not depends on the incentive for the largest shareholder. If he is satisfied with his share of cash flow then he will refrain from tunneling, and his interests are aligned with those of small investors. This happens only in combination with low debts (leverage) or large firm size. Six out of eight configurations apply to firms with relatively low leverage, meaning that low indebtedness is also accompanied by low inter-firm loans. The few bank loans that they have may not allow them to embark on inter-firm loan schemes or possibly, they have low debts because they object to tunneling, thus keeping their financial needs low. Finally, every configuration except one includes at least two of the three conditions: large

controlling shareholder, low leverage and large firm (see table 10 for the solution subset). Under these conditions, the controlling shareholder is likely satisfied with the income he receives, likely from large firms. These observations are the exact mirror of those obtained for tunneling in the previous section, thus exhibiting very symmetric results. *This confirms and strengthens the findings in section 4.2 regarding the incentives and the mechanisms involved in tunneling behavior.* Much like the results of the previous section, these findings are in line with propositions P1a and P1b, aside from the departures discussed earlier. In addition, the only two configurations that display very concentrated ownership (6 and 7), with both a large controlling shareholder and large minority investors present, include each of the three conditions limiting tunneling incentives and mechanisms.

Table 10. Incentives and mechanisms

	1	2	3a	3b	4	5	6	7
Large controlling shareholder	●	•	●	●	●	●	•	●
High leverage			∅	∅	∅	∅	∅	∅
Large firm		●	∅	∅	●	●	●	●

Corporate governance practices. The symmetry argument does not apply to the design of bundles of corporate governance practices. While it has been shown that tunneling is combined with a disregard for the corporate governance blueprint as stipulated in the laws and regulations, low tunneling cannot be linked to a commitment to such standards. *If the tunneling incentives and mechanisms are absent, a commitment to corporate governance practices is not necessary to prevent tunneling.* Indeed, only two configurations involve the presence of more than one governance practice (independent board, independent audit or proactive disclosure). If there are incentives for tunneling, the dismissal of corporate governance procedures enables tunneling. Yet if there are no incentives for tunneling, then such components of good governance do not matter. This implies that good governance alone is a weak tool for preventing tunneling. While the first analysis was coherent with proposition P2, these results show that the association theorized in the proposition is not symmetric since governance mechanisms do not prevent tunneling if incentives are present. There is one exception to this finding. Configuration 1 displays only one condition out of the here conditions that reduce the incentive for tunneling; it has a large controlling

shareholder, but not necessarily a low leverage or a large firm size. Interestingly, it is also the only configuration that requires both proactive disclosure and independent audit. A deeper investigation of this configuration could provide valuable insights about the effectiveness of control mechanisms in these firms, especially to contextualize the complementarities between audit and disclosure, but such an endeavor falls outside the boundaries of the present study.

The only instance of symmetry with the results from the first analysis lies in role of proactive disclosure. Including configuration 8 (private firms), strong disclosure appears as a causal condition in five out of nine configurations, while none of the solutions rely on weak disclosure. In particular, disclosure is present in every configuration of small firms and those in which large minority shareholders are absent (see table 11 for the solution subset). This suggests that *disclosure is especially sensitive when the state has a large controlling stake in small firms or in firms where all the other shareholders are relatively small*. The conjunction of proactive disclosure and small minority shareholders leading to *absent tunneling* is the symmetric corollary of the theoretical prediction made in proposition P3. The proposition posited that absent disclosure and present large minority shareholders lead to tunneling. The results reported here show the opposite, that disclosure and absent large minority shareholders lead to absent tunneling.

Table 11. Disclosure complementarities

	1	2	3a	3b	4	5	6	7
Large minority	∅	∅	∅				●	●
Proactive disclosure	●	●	●	●				
Large firm		●	∅	∅	●	●	●	●

The floating ratio. The assumption of the China-specific literature that a low floating ratio (proportion of tradable shares on the stock exchange) almost forces firms to embark on tunneling gets questioned by the results (see table 12 for the solution subset). While a high proportion of tradable shares is a causal condition in three configurations producing absent tunneling (2, 5 and 6), three other configurations rely on a low floating ratio (3a, 3b and 4). It appears that the effect of the floating ratio depends on interactions

with board independence and firm size. Firstly, in the four configurations where both “float” and board independence appear as causal conditions, their presence and absence are aligned. In other words, the floating ratio and board independence display symmetric complementarities. *When the state has a large controlling stake, the shareholders of a firm with limited exposure to the capital market are better served by insiders on the board of directors. Conversely, the monitoring role of external directors is more salient in firms that are more exposed to capital markets.* These complementarities are also partly supported in the analysis on tunneling in section 4.2, but in the form of misalignment. Indeed, in three out of four configurations where float and independent board appear in the causal set for tunneling, their presence or absence is opposite. This suggests that more research is needed on voice and exit options as manifested by float and independence.

Secondly, the presence and absence of the conditions float and large firm are also aligned in five out of six configurations in which they both appear. This suggests that *when the state has a large controlling stake and the firm is well exposed to the capital market, shareholders are better treated if the firm is relatively large.* Possibly, the trading volume in large firms is higher, thus providing small shareholders with a more concrete exit option. *In smaller firms, limited exposure to the capital market contributes to the mitigation of the principal-principal problem.* For example, the relative weight of each investor might be higher in smaller firm, allowing more reliance on voice rather than exit as a control mechanism.

Table 12. Floating complementarities

	1	2	3a	3b	4	5	6	7
Float	●	∅	∅	∅	●	●	●	∅
Board independence	∅			∅	∅	●	●	∅
Large firm	●	∅	∅	●	●	●	●	●

Private firms. Configuration 8 is the only one that applies to private firms. In this sense, private firms offer a picture that does not allow identifying clusters or dominant configurations. This indicates that private firms that don’t engage in tunneling are still undergoing a process of experimentation with different and shifting corporate governance mechanisms. Also, as the only one that applies to private firms, configuration 8 is strikingly

different from SOEs. The proportion of shares of the largest shareholder doesn't play a dominant role, nor does the floating ratio. It does not rely on low firm indebtedness, thus excluding two of the conditions limiting tunneling incentives and mechanisms. It neither displays a strong commitment to corporate governance practices. Still, the fact that this configuration relies on large minority investors and that it requires proactive disclosure makes it somewhat in line with proposition P3, namely that disclosure plays an important role in the presence of large minority shareholders. Specifically, *proactive disclosure and an insider-dominated board are important to mitigate principal-principal problems in firms with large minority shareholders and a relatively small private controlling shareholder*. Interestingly, the fact that an insider-dominated board has a positive effect in the context mirrors the finding of the previous section that independent directors are conducive to tunneling in the presence of large minority investors. Again, this is the only configuration that could be recorded regarding private firms, so any interpretation based on it is limited.

To summarize, there are three main findings from this analysis. Firstly, the conditions that set the incentives and mechanisms for tunneling in the first section have a symmetric effect. Specifically, any two of the following three conditions is sufficient to set disincentives to engage in tunneling behavior: large controlling shareholder, low leverage and large firm size. Secondly, while a lack of commitment to best corporate governance practices had been found to enable tunneling, governance mechanisms do not matter in the absence of tunneling incentives. Also, provided that there are tunneling incentives, corporate governance mechanisms cannot deter the diversion of cash flow. Finally, while the solution identifies a few dominant configurations for SOEs with low tunneling, there is a large diversity of forms among private firms that cannot be synthesized in the current research design.

4.5 Limitations

This research is not without limitations, a number of which are common to every study using the QCA method. Firstly, QCA does not allow time series. The year was carefully chosen based on data availability, comparability with the existing literature and recency. Still, the findings would benefit from additional analysis using data from a longer time period to

ascertain that the results are not time specific. Secondly, a QCA output does not offer an exhaustive view. The configurations presented in the solution sets do not cover every firm in the sample. Still, the sample includes 99% of the population and the overall coverage compares advantageously with equivalent studies. Also, although a larger diversity of configuration exists in the entire population, the solutions offer the most common bundles of conditions that produce the outcome. Thirdly, QCA uses a limited number of conditions. As opposed to statistical methods, set theoretic methods cannot include an exhaustive list of control variables. Still, in order to cover the most important factors, a relatively high number of conditions are used, which increases the challenge of presenting the findings in an understandable and compelling way. To help the reader, tables were used to present subsets of the solution to highlight the argument. These subsets cannot however be understood in isolation because configurations consist of indivisible coherent bundles of causal conditions. It is also relevant to note that the use of an overly large number of control variables in statistical models has drawn recent criticism (Davis, 2010). Fourthly, this study concerns only one type of tunneling. Although inter-firm loans have been identified as the most prominent kind of tunneling transactions in China, additional research would be warranted to verify the applicability of the findings to other forms of expropriation.

5 DISCUSSION AND CONCLUSION

One of the main objectives of this study is to bridge new insights from the literature on complementarities and substitution effects in firm level corporate governance practices and the increasingly large body of empirical work on principal-principal problems. A new methodological approach, the fuzzy set QCA, is used to study the issue of tunneling behavior from a configurational perspective (Fiss, 2007). This set theoretic method allows to treat governance structures as bundles and to contextualize practices in relation to the surrounding causal conditions (Aguilera et al., 2008). In the field of corporate governance, this method is increasingly used in comparative corporate governance and in studies focusing on principal-agent problems (Garcia-Castro et al., 2013). Its main advantage is to emphasize the interdependencies among conditions instead of looking at the additive effects of practices

taken in silo. As Misangyi and Acharya (2014: 1703) put it, “to truly understand governance effectiveness, we must stop thinking about the mechanisms in isolation”.

This article shows that configurational analysis is particularly well suited to examine the controlling shareholder expropriation problem because it can unravel the causal complexity of the phenomenon and it recognizes the diversity of causal paths that can lead to the outcome. Specifically, the fsQCA method was used to study data from 1337 Chinese listed firms in 2005 to find the complementarities and substitutions that explain the presence and absence of tunneling in the form of inter-firm loans. Tunneling behavior depends on a number of conditions involving the ownership structure, the commitment to best practices of corporate governance, whether a firm is private or state-owned and on key financial factors, namely firm size and leverage. By examining the interaction effects and the causal asymmetry that shape principal-principal problems, the empirical study lays a number of conceptual building blocks that offer a starting point to reconcile the many equivocal results that have beset the literature. The findings raise a number of interesting questions.

The first findings concern the incentives and mechanisms that drive tunneling behavior. Firstly, the results unambiguously show that the main effect of the proportion of shares of the largest shareholder rests in the income rights, which determine the alignment or misalignment of interests with minority investors. This confirms that a relatively low ownership concentration at the very top represents the main incentive for tunneling (Claessens et al., 2002; La Porta et al., 2002). Secondly, one of the two main mechanisms employed in tunneling that emerge from the study is that insiders obtain funds by contracting debt from banks and subsequently tunnel this money to related parties through inter-firm loans. Indeed, a high leverage is found to be a key condition leading to tunneling, which is in line with the results of other studies (Jiang et al., 2010; Wang & Xiao, 2011; Yeh et al., 2012). Thirdly, the other mechanism identified lies in the vulnerability of smaller firms. Previous studies had shown that the more there is tunneling through inter-firm loans, the larger is the proportion that can be traced to a parent company (Jiang et al., 2010). That small firm size appears as a key condition for tunneling suggests that these firms are more easily subject to expropriation by larger corporate entities. Small investors are thus more vulnerable to tunneling in small firms, which confirms the results of Wang and Xiao (2011).

Insights from the studies of Jiang et al. (2010) and Cheung et al. (2010) about malpractice in local SOEs had suggested that this effect would predominantly apply to state controlled firms, but the present findings show that it also applies to private firms. The fact that the results on the effect of firm size run counter to those of Huyghebaert and Wang (2012) and Yeh et al. (2012) might be explained by the fact that large firms may also be involved in related party loans, but that their position may be less detrimental to small shareholders because larger firms may act as transaction hubs on the receiving end of the inter-firm loans. This specific relation would benefit from additional research. Finally, the analysis shows a three-way partly substitutive and partly complementary interaction among these three conditions. Nearly all configurations that display at least two conditions (small firm, high leverage, low shareholding by the largest shareholder) lead to tunneling behavior. This interaction is fully symmetric since nearly every configuration that displays at least two of the opposite conditions (large firm, low leverage, high shareholding by the largest shareholder) lead to the absence of tunneling.

The second group of findings concerns the role of corporate governance practices. The most salient effect occurs when tunneling incentives and mechanisms are in place. Then, the absence of a commitment to governance plays an enabling role towards tunneling. The only systematic and symmetric effect concerns proactive disclosure. Its absence is a causal condition in every configuration leading to tunneling and its presence contributes to a majority of configurations that do not produce tunneling, especially those that involve small firms or small minority shareholders. This evidence validates empirically the preference of outsiders for strong disclosure practices reported by Liu (2006b). The absence of disclosure alone is not sufficient to act on tunneling incentives. It must be complemented by the absence of at least one other governance practice. In configurations that do not rely on large minority investors, the complementary condition may rest in either the absence of rigorous internal audit or the absence of board independence. This lends some support to the idea of a complementary monitoring role among corporate governance practices (Aguilera et al., 2008; Cheng & Courtenay, 2006). In configurations that do rely on large minority shareholders, board independence exhibits an asymmetric effect that will be further discussed below. Yet, in this context, a low floating ratio appears to offer an additional possible complementary condition with absent disclosure. This lends support to the claim

that the floating ratio may be a valid measure of governance (Wang & Xu, 2004), but its effect is mostly bounded to configurations that rely on large minority investors. In sum, the results show that, in the presence of tunneling incentives, while the absence of commitment to best corporate governance practices plays an enabling role for expropriation, a strong commitment to governance cannot effectively deter it. Furthermore, in the absence of tunneling incentives, the monitoring role of mutually reinforcing corporate governance practices is not relevant.

The third main finding concerns the specific role played by independent directors in principal-principal problems. The effect of board independence is one of the most disputed elements in the literature and has produced unsettling and equivocal results in past empirical work. In turn, board independence has been found to deter tunneling behavior (Liu, 2006b; Liu & Lu, 2007), to contribute to it (Su et al., 2008) and to be merely symbolic or insignificant (Chen et al., 2011; Huyghebaert & Wang, 2012; Peng, 2004). The present study provides very interesting results that shed light on the interactions that drive the asymmetric effect of board independence. Most importantly, when tunneling incentives and mechanisms are in place, board independence is detrimental when combined with state control or large minority investors. In the case of SOEs, this finding lends support to the idea that board nominations are used by state agencies as a rent generating mechanism to reward friends of the regime and ensure the prioritization of political objectives over the wealth maximization of shareholders (for a discussion on the Party Nomenklatura system, see Brødsgaard, 2012). In the case of firms with large minority shareholders, independent directors are instrumental to the alignment of interests among the most prominent principals and contribute to tunneling behavior. The results obtained by Faccio et al. (2001) to the effect that the presence of large minority shareholders in Asia do not contribute to effective monitoring like those in Europe but rather engage in collusion with the controlling shareholder are contingent upon a large proportion of independent directors on the board. Otherwise, in every configuration leading to tunneling that involves neither state control nor large minority investors, the reliance on absent board independence confirms the monitoring role independent directors and that the controlling owner of private firms that have relatively low shareholding will prefer to set up an insider-dominated board if they are to engage in tunneling. Finally, the results show an additional symmetric complementarity between board independence and the

floating ratio. The alignment of the presence or absence of these two conditions contributes to a positive outcome. In other words, an insider dominated board plays an effective monitoring role in firms that are less exposed to the capital markets while an outsider-dominated board plays an effective monitoring role in firms that are more exposed to the capital markets. Additional research would be desirable to provide a more substantive explanation about this interaction.

Taken together, these findings contribute to the corporate governance literature in several ways¹² by identifying firm-level interdependencies among corporate governance practices, including asymmetric effects and functional equivalents. The corporate governance problem analyzed in this chapter, the controlling shareholder expropriation problem through related-party transactions, is the most salient problem in Asia and China. The large number of studies on the issue provide conflicting and equivocal results mainly derived from statistical methods and fail to identify a consensual set of determinants of tunneling behavior (Chen et al., 2009; Huyghebaert & Wang, 2012; Jiang et al., 2010; Wang & Xiao, 2011). In this chapter, the use of a configurational method has allowed to consolidate the literature by identify two main and distinct components in the problem. Three drivers of tunneling behavior provide the incentives and mechanisms for firms to engage in related party loans. Then, several features of monitoring affect the ability of controlling shareholders to achieve expropriation. While the drivers are stable across configurations, the effective set of monitoring practices depends on the ownership structure. Most importantly, the findings show that within each component (drivers, monitoring), causal conditions may at the same time be complements and substitutes. This is a direct extension of the work of Garcia-Castro et al. (2013) and Misangyi and Acharya (2014) on principal-agent problems.

The study clarifies, in the context of ill-functioning legal institutions and weak property rights, under which types of ownership structure a lack of commitment to best corporate governance practices enables a misalignment of interests between controlling shareholders and minority investors. Because of its socialist past, China carries a tradition of government involvement and of weak protection of formal property rights. The findings reported above

¹² See the general conclusion for a detailed discussion of the contributions.

show that the heritage of the common property regime still weighs on corporate governance structures in listed firms. The deployment of the state agents through board directorships in SOEs hurts the interests of small shareholders. Finally, the findings support the view of Filatotchev and Allock (2010) and Garcia-Castro et al. (2013) that, given the causal complexity of corporate governance embodied in complementarities, substitution effects and asymmetry, a soft law approach of “comply or explain” might be better suited as one size doesn’t fit all (Arcot, Bruno, & Faure-Grimaud, 2010; MacNeil & Li, 2006). Yet, the prominent importance of disclosure in the results suggests that such an approach might be contingent upon the actors’ access to reliable information to be empowered to conduct effective monitoring. To conclude, this article shows that coherent bundles of governance mechanisms that could effectively prevent tunneling even in the presence of incentives are still to be designed.

CHAPTER 3 – POLITICAL EMBEDDEDNESS AND CORPORATE GOVERNANCE: HETEROGENEITY AND HYBRIDIZATION IN CHINA

Abstract: Chinese listed firms must navigate between far reaching corporate governance reforms and resilient institutions of political embeddedness. Firms come up with diverse solutions for combining corporate governance with the requirements of their political and economic environment. To capture the heterogeneity, this chapter applies a research design based on configurational analysis using fsQCA which allows comparing private firms with state-owned firms. The results show that (1) there is indeed considerable heterogeneity of forms of corporate governance in China, (2) that political embeddedness plays an important role especially in SOEs, (3) that both insider-control models and outsider influenced models coexist, (4) that several functional equivalents and neutral permutations prevail among governance practices and (5) that hybrid forms emerge. These findings demonstrate that some of the inherited institutions of political governance are evolving within consistent configurations that can reliably lead to firm performance. This suggests that the conceptualization of reforms as a linear transition from central planning to western-style market institutions misses the complexity induced by institutional tensions.

Keywords: China, political embeddedness, transition economy, configuration analysis, corporate governance, QCA.

JEL Classifications: G32, G34, K22, O17, O53, P21, P31

1 INTRODUCTION

That we find a multitude of corporate governance forms worldwide cannot come as a surprise. After all, corporate governance today refers to more than the alignment of interests between firms in search of investors and investors in search for sufficiently high and steady returns on their capital. One way to empower investors is to offer them control rights in addition to the income (cash flow) rights usually harnessed by national legislation. In turn,

the degree to which the law enforces the rights of investors (owners) to limit the discretionary power of the top management differs across countries. The field of Comparative Corporate Governance has identified two models primarily theorized based on listed firms: the Anglo-Saxon model derived from the British and American markets and a continental European model mostly inspired by the German market (Aguilera & Jackson, 2003; Shleifer & Vishny, 1997). The former model was specified as one of outsider control characterized by dispersed ownership, strong shareholders' rights, an independent board, incentives compensation for the management, and a market for corporate control. The latter in contrast, called insider control system, relies on concentrated ownership, a two-tier board and multiplex relationships with powerful stakeholders. This dichotomy between insider and outsider control systems was first put forward in Jenkinson and Mayer (1992) and Franks and Mayer (1997), and more recently synthesized in Garcia-Castro, Aguilera and Arino (2013). As important as these studies have been for the analysis of corporate governance, recent empirical work has proved that they offer a too simplistic view. They don't allow domestic heterogeneity (an exception is Whitley, 2006), they make it hard to employ their models to those markets, like transition economies, where investors cannot rely on accompanying legal empowerment, and they disregard the strong ties between the corporate elite and the political elite (exceptions here include studies on the link between political regimes and corporate governance, such as Hall and Soskice's (2001) enquiry on the varieties of capitalism and Mark Roe's (1991, 2000, 2003) legal studies research agenda on politics and firm ownership structures). However, there is little research on political connections and firm level corporate governance structures.

The concept of political embeddedness offers a promising supplement to the conventional corporate governance analysis. Political embeddedness has been defined as a "specific form of social embeddedness characterized by a mix of formal and informal ties with political agents" (Krug, 2012: 347; see also Grabher & Stark, 1997a, 1997b). Regarding corporate governance, political embeddedness specifies the principal-agent problem by integrating political actors as an influential stakeholder whose interests may conflict with those of economic principals, i.e. shareholders. The integration of these concepts into firm-level analyses allows going beyond the question of why a multitude of different forms of governance exist, but instead pursuing the question of how well-functioning and profitable

firms with different forms of corporate governance coexist within a single jurisdiction. The debate around whether politics nourishes or harms the performance of firms, elegantly presented by Frye and Shleifer (1997) and Shleifer and Vishny (1998) as a contest between the competing hypotheses of the Helping Hand and the Grabbing Hand of the state, is so far unresolved. For instance in China, there is evidence of a positive effect (Peng & Luo, 2000), supporting some form of the helping hand hypothesis whereby political connections provide access to resources, discipline management and reduce policy uncertainty. There is also evidence of a negative effect (Fan et al., 2007), supporting the Grabbing Hand hypothesis which suggests that political agents pursue goals that diverge from the financial interests of shareholders leading to misallocation of resources, over-employment or disproportionate compensation (Shleifer & Vishny, 1994).

The Chinese case offers a fertile ground to study the impact of political embeddedness on corporate governance structures. As a transition economy, reforming state-owned enterprises (SOEs) has been considered a core objective of market oriented reforms in China since the early 1990s (Qian & Wu, 2003). The government wanted to downsize the state sector by privatizing its assets. For this purpose, the two mainland stock exchanges were created as a mechanism to corporatize SOEs (Allen & Shen, 2012). Moreover, several laws were adopted clarifying economic performance criteria and attempting to separate the functions of management and ownership. Over the years, the Chinese legal framework for corporate governance has largely become a transplant of Western best practices, with the difference that ownership rights were clarified only recently. Such a shift could bring about important systemic changes promoting financial development: promote “scientific management” by shielding decision making from the political agenda and protect the income rights of small individual shareholders since stock exchanges draw an important portion of domestic savings. While the Chinese state has implemented reforms for the purpose of empowering private investors and reining in undue political interference, a relevant question is whether the observed reality has actually translated these intentions into practices, especially in firms that perform well. Indeed, the old structures of political governance appear to have remained effective in a large proportion of listed and non-listed firms, not only in the form of state ownership, but also through networks of political connections in the private sector. The Party maintains influence in listed firms through Party committees

and the affiliation of top executives to the Party Nomenklatura (Brødsgaard, 2012). Chinese firms, as in any other transition economy, are thus facing increasingly strong market forces and are coerced into adopting governance structures modelled on the outsider-control system imported from the West, while at the same time still relying to a large extent on insider control, mostly executed by large former state firms, and on the persistent institutions of political embeddedness that transfer residual control rights to political cadres.

The following study aims at contributing to the literatures on political embeddedness and on comparative corporate governance by identifying those firm-level corporate governance configurations that lead to economic performance. Three main models are identified in the above-mentioned literature: an insider-control system and an outsider-control system (Franks & Mayer, 1997), and an inherited Chinese model of political governance (Brødsgaard, 2012). The present exploratory study aims at answering the following question: what dominant model(s) can be observed in successful Chinese listed firms one decade after the introduction of laws set to professionalize corporate governance practices? The primary research objective is therefore to look into the domestic heterogeneity of governance forms (Whitley, 2006), which suggests that the distinct ideal-type models identified across countries coexist within a single jurisdiction. Is there heterogeneity? If so, does this heterogeneity conform to ideal-type systems? Indeed, beyond the co-existence of forms, this study aims at identifying ‘hybrids’, whereby firms recombine elements pertaining to different models to create novel corporate governance configurations (for examples see Boisot & Child, 1996; Nee, 1992). Finally, are there still successful politically embedded forms of governance? If so, do these forms mainly prevail in state owned enterprises?

This chapter presents an inductive exploratory study that investigates the recent Chinese landscape of corporate governance configurations. The research design applies a set theoretic method on two large samples of Chinese firms. The first sample contains 942 private firms. The second concerns 810 SOEs. The decision to divide the population into two separate samples rests on the idea that the private sector and the state sector operate under distinct institutional contexts. In line with previous studies (Ding, Jia, Wu, & Zhang, 2014; Nguyen & van Dijk, 2012), we thus adopt a comparative approach to the private and SOEs sectors which allows not only to highlight the differences but also document the

specific corporate governance features adopted by SOEs which have received little attention in the literature (Mahadeo & Soobaroyen, 2012; Sokol, 2010). This configuration analysis is operationalized with the fsQCA software to identify the dominant governance models that have produced above-average performance in each sample (Fiss, 2007; Ragin, 2000, 2008a; Ragin et al., 2006). Such a method is helpful to study complex causal relationships. It allows for equifinality, meaning that many distinct configurations may lead to the same outcome. Also, it facilitates the analysis of multiple interactions among variables, including asymmetric effects as certain configurations may rely on the presence of a condition while other configurations may rely on the absence of the same condition. The models used here are based on the governance conditions that feature centrally in the ideal-type models identified in the literature: board independence, participation-enhancing measures during shareholders' meetings, proactive disclosure, management incentives, large minority shareholders, the proportion of shares of the largest shareholder, and an active supervisory board. To account for the China-specific context of inherited political embeddedness, the model also includes conditions of political ties at the individual level, differentiating political connections among top officers generally (board of directors, top executives, board of supervisors) and political connections at the leadership level (CEO, board chairman). For the SOE sample, an additional condition is used to account for an institutional divide in terms of ownership: whether firms are ultimately controlled by a traditional state agency or by the central asset management commission (SASAC) (see Wang, Guthrie, & Xiao, 2012). This specific institutional feature was selected over alternatives such as a central-local dichotomy because the SASAC is a mid-range institution that was specifically set up by the government to distance asset supervision from the State Council, which represents an explicit distinction regarding political control and governance.

The results display a high level of heterogeneity of governance forms among both private firms and SOEs. Four distinct models emerge from the sample of private firms. Two models are close kin to the outsider-control system, one relying mainly on *market pressure* as a disciplining mechanism and the other making room for *outsiders' voice* through the internal governance structure. The two other models are versions of the *insider-control* system and the *politically embedded* model. Three main models are identified in the SOE sample. The *external pressure* model concerns firms with a relatively small controlling shareholder and

presents two distinct variations. One is closest to the outsider-control system and the external pressure is exerted by market forces. The other is politically embedded and external pressure comes from political agents. The second model is very close to the *insider-control* system. The last model is labelled *national champions* as it concerns firms ultimately controlled by the SASAC. The sample of private firms exhibits a higher level of adherence to fewer configurations, while there seems to be a higher diversity of models that lead to performance among SOEs. Among private firms, the two causal paths that involve political connections both rely on a politically connected leadership (CEO or board chairman), signaling that political connections generally may not be beneficial without a connected leadership. Yet, among the firms covered by the solution set for private firms, only 23 out of 205 involve political connections. While this shows that some politically connected forms are still used by successful firms in the private sector, most dominant governance models among private firms are exempt from any form of political embeddedness. Not surprisingly, a majority of models among SOEs involve political embeddedness. However, as opposed to the sample of private firms, political leadership is absent from seven out of the eight configurations that emerge from the analysis. While 30% of SOEs have a politically connected leadership, less than 6% of firms in the solution set do. This indicates that a politically tied leadership in the state sector is most often not beneficial to firm performance. Finally, some SOEs exhibit practices that usually belong to systems of outsider-control, which shows a degree of adaption in the state sector to new norms of corporate governance. This is especially true where the state has a relatively small controlling stake, which amounts to a mild form of ownership dispersion.

These results are important in several ways. Firstly, despite the dichotomy that typically characterizes national systems of governance, there is a high level of heterogeneity of corporate governance forms in well-performing firms in the Chinese landscape. Secondly, the study documents the emergence of hybrid forms of governance that diverge from the clear-cut ideal types discussed before. These creative blends demonstrate that practices that are claimed to pertain to distinct models are not necessarily devoid of complementarities. For instance, the presence of SOEs with mild dispersed ownership that rely on large minority shareholders and active supervisory boards dispels the idea that large state-run enterprises are ill-equipped to draw capital from a large pool of investors on the market to achieve

performance. Another example is the existence of private firms with concentrated ownership that rely on various mechanisms strengthening outsiders' voice, which shows that even a firm with a large dominant controlling owner can gain from adopting practices that empower external investors to actively participate in the governance structure. Thirdly, the continued success of some firms that still rely on political connections suggests that the old multiplex relationships are adapting to new corporate structures, sometimes even acting as functional equivalents to some of the new practices to discipline management. This leads to believe that many institutions inherited from the command economy are not simply vanishing in the wake of market oriented reforms, but adapting and contributing to the emergence of hybrid forms. In essence, political agents have invested new bodies of decision making brought about by the recent wave of corporate governance reforms. Yet, most dominant models of profitable firms in the private sector concern firms that have moved beyond political governance. To sum up, the legal framework in China is spacious enough to accommodate a heterogeneous pool of governance forms, both among private and state-owned firms.

The remainder of this chapter is organized as follows. The next two sections are meant to provide the contextual and conceptual underpinnings of the exploratory study. Section two presents an applied perspective of the concept of political embeddedness by providing a detailed account of the Chinese experience in terms of reforms and of the networks between large firms and the political elite. The section also discusses the possible impacts of political connections on firm performance. Section three lays the theoretical groundwork for the corporate governance analysis. It starts by presenting the two main ideal-type models that dominate the comparative corporate governance literature: the insider-control system and the outsider-control system. An explanation of these models is necessary since their features and the interactions among them inform the selection of corporate governance conditions that are used in the exploratory empirical study. Apart from presenting the ideal type models, section three contains a theoretical discussion about (1) domestic heterogeneity to conceptually justify an inductive study that aims to break the mold of unitary national systems, (2) about China's specificity to provide insights about how features of political embeddedness may interact with the features of the two ideal-type systems and (3) about hybridization to introduce the idea that features of different ideal-type systems may be deconstructed and recombined. Section four presents the methodology, including the sample

description, calibration of conditions and operationalization. Section five presents the results for each sample. Section six concludes with some limitations and avenues for future research.

2 POLITICAL GOVERNANCE AND POLITICAL EMBEDDEDNESS IN CHINA

2.1 Corporate Governance Reforms: An Issue of Depoliticization

The transition from political governance to corporate governance was the biggest challenge in the privatization and corporatization of state assets in China. Portraying the reform of SOEs as a cornerstone in establishing arm's length business to government relations, Qian and Wu (2003) argue that the implementation and professionalization of corporate governance practices was the most crucial but difficult step in the reform of state assets. In other words, reining in political governance requires a fundamental realignment of allegiance among professional managers to the firm's autonomy and to its shareholders. In September 1999, the fifteenth Party Central Committee pledged itself to a wave of important reforms, signaling the withdrawal of the state from a wide array of economic sectors. Still, the Party expressed its intention to maintain control over strategic sectors, including industries related to national security and public goods, but also to natural monopolies and high technology champions. For those national champions, the reforms brought about a dislocation in the chain of command by creating the State Assets Supervision and Administration Commission (SASAC), an intermediary of the government directly under the State Council solely dedicated to managing and monitoring central state assets (Wang et al., 2012). In 1999, the Party Central Committee also made reference for the first time officially to the term corporate governance, as a mechanism to allocate decision making rights, align incentives and formalize control (Qian & Wu, 2003). This was deemed necessary to accompany the diversification of ownership pursued using listings on the stock exchanges, by which the state could transfer control stakes or minority stakes of equity in SOEs to private investors. Corporate governance reforms became, and still are, a major policy issue in China. The Chinese state has vowed to transform the corporate field from political steering towards capital market based governance mechanisms.

For the Chinese leadership, achieving a dynamic, liquid market has many systemic benefits. Generally, such financial development supports economic growth, capital accumulation and technological progress (King & Levine, 1993; Levine, 1997). An efficient market of financial intermediaries improves firm productivity in developing countries (McKinnon, 1973), which holds true in both cases of banking development and stock market liquidity (Levine & Zervos, 1998). More specifically, especially in fast growing economies, financial development is necessary to improve firms' access to external finance to adequately meet expansion needs (Rajan & Zingales, 1998). Evidence suggests that large Chinese firms listed simultaneously in China and abroad (i.e. Hong Kong, New York) raised most of their fresh capital on foreign markets while domestic exchanges ended up floating equity that was largely owned already by incumbent shareholders prior listing (Allen & Shen, 2012). To level the playing field, the Chinese leadership had an incentive to professionalize the corporate governance of listed firms through formal standards to improve their ability to raise capital by increasing investors' confidence. Indeed, corporate governance laws and codes have been found to improve capital markets and increase their efficiency to attract capital and channel domestic savings (Aguilera & Cuervo-Cazurra, 2004).

The effective drive towards professionalization and standardization really took off in China around 2001 with the adoption of the first code of corporate governance. Over the following decade, many laws and regulations were implemented to improve the protection of minority shareholders' interests in publicly traded firms. These objectives motivated the promulgation of the new Company Law and the new Securities law in 2006 to strengthen the supervision and regulatory management system. These laws introduced new standards of disclosure regarding the timeliness of reports, the background of managers and directors, the identity of the largest shareholders and their relationship with managers. Formal procedures for shareholder's meetings would allow small shareholders to nominate directors, submit proposals, use proxy voting and normalize the rule of *one share one vote*. The legal liabilities of top executives and the criminal punishments for insider trading and partial disclosure were both strengthened (Chen et al., 2009). These major reforms were complemented by the Guidelines for protecting investors in the SME listing board and the Rules on Supervision over Securities Companies in 2008.

The point to note here is that the introduction of the new company and securities laws indicates a commitment to further company and capital market reform. It clarified that the reforms did not only aim at downsizing the state sector, but also replacing political control structures with “Western style” corporate governance. Reducing the dependence on state and state bank alimentation and opening the way for firms to refinance themselves by other (capital) market means would eventually improve the allocation of decision making rights in the firm and improve its governance and management.

2.2 The Resilience of Political Embeddedness in China

Overall, the efforts to stimulate private businesses and downsize the state sector have been successful. The proportion of listed firms that are ultimately controlled by a state agency dropped from over 80% in 2001 to 45% in 2010. Privately controlled firms increased from 10% to over 50% during the same period. Still, this successful formal transition in the state sector doesn't convey the whole story. While more firms are ultimately controlled by private parties, the OECD estimates that no less than 83% of market capitalization was still held by the state in 2007 (OECD, 2011b), taking into account both firm size and the ubiquitous cross-shareholding among listed firms. Also, two decades after their creation, the main Chinese stock exchanges remain rather small relative to the surrounding economy, most governance mechanisms are ill-functioning and prices are volatile. In this context, many functions of full-fledged stock markets are not supported, including risk hedging but also prices that do not act as a potent signaling and external disciplinary mechanism (Allen & Shen, 2012).

Even more important is the lagging enforcement that allows a gap between formal law and actual practices (Opper & Schwaag-Serger, 2008). Resistance to the implementation of new norms and practices in organizations should be expected to be met with resistance by those whose behavior the new norm is constraining. The tolerated disconnect between technical activities and the organization's structure has been labelled decoupling (Fiss & Zajac, 2004; Meyer & Rowan, 1977). Regarding corporate law, “surface compliance may suffice where deep control is impractical, or indeed, impossible” (Fiss, 2007: 20). For instance, Carpenter and Feroz (1992, 2001) show that new accounting standards were often adopted by US states

to keep the books up to best practices expected by markets and credit agencies, without really enforcing the new measures. This decoupling view is useful to understand the Chinese context, where *de jure* corporate governance requirements are strict, while the weak judicial system cannot enforce *de facto* implementation. Local courts are not independent, and often subject to interference from local Party units (Findlay, 1999). Even winning cases are not necessarily followed by effective enforcement. Opper and Schwaag-Serger (2008: 259) report that not more than 60% of business rulings are duly enforced. Also, the state being a major shareholder in a majority of listed companies in China, the legitimacy of corporate insiders to let practices diverge from the legal norm is implicitly acknowledged institutionally by the owner, the law maker. Yet, there is no consensus in the empirical analysis of Chinese firms on whether SOEs are more law abiding due to the stricter political control, or less so due to the ability of state agencies at the local level to facilitate and ‘protect’ non-compliance.

For this reason, and perhaps highlighting one of the main distinctions of the Chinese system, the legal discussion overlooks the informal institutions embedded in bottom-up business practices that may moderate the effectiveness of corporate governance reforms. Despite a push for *scientific management*, political governance is a resilient force in the Chinese system. Even in the private sector, as is further discussed below, firms are influenced by informal forces where political networks inherited from the past are tightly woven into the networks of the new economic elite. In this context, a firm’s corporate governance structure is shaped by a negotiation for which the outcome is hardly predictable.

Indeed, the hierarchy of actors in decision making in Chinese listed firms is puzzling. Using a survey of Chinese listed firms in 1999 conducted by the Shanghai Stock Exchange about decision making power of various actors (BOD, shareholders' meeting, managers, local Party committee, state administration agencies) regarding 63 types of corporate decisions, Nee, Opper, and Wong (2007) report that directors (3.61/5), managers (3.02/5) and shareholders (2.66/5) had higher average decision making power than Party committees (1.65/5) and government agencies (1.25/5). The five decisions in which the Party committee had the highest decision making power were all personnel-related decisions: selection department, branch and subsidiary managers, and selection of vice-CEO. Except for the

election and dismissal of the board chairman, the five decisions over which government agencies had the highest power are concentrated in financial matters: merging with or being merged by other firms, changes in shareholding structure, determining share placement and new issues. On the surface, this seems to suggest that, even before the recent wave of reforms, the allocation of decision making power rested more in corporate rather than political governance bodies within Chinese listed firms.

Allen and Shen (2012: 173) provide a very different portrait of the role of Party committees in listed firms, especially in SOEs, describing their members as having a much wider influence than would be suggested by only looking at the committees' official roles. They explain that the committee is "headed by a Party secretary, who will often sit on the company's supervisory board, will direct the voting of state-controlled shares, will nominate both "independent" directors and insiders, and will have significant influence in designating or dismissing the CEO". So while officially the range of tasks mandated to the committee specifically is limited and often subordinate to other decision centers, the people actually sitting around the table wear many hats. Distinguishing decision making rights and liabilities across various governance bodies within the firm is pointless if the Party secretary also represents the largest shareholder, thus nominating directors, therefore choosing managers, while sitting at the supervisory board. From this perspective, the role of the BOD is still largely ceremonial and the important decisions are made by Party members within governance units that are accountable to none but the Party itself.

This view of political interference exercised by internal Party committees is supported by Wong, Opper, and Hu (2004). In the context of partial privatizations in China, Party committees are a vehicle for political control by the central leadership of the Party. The authors explain that the committees have formal authority to "supervise Party cadres and any other personnel" (Wong et al., 2004: 33), but that path dependency following an era of total formal control by political bodies suggests that the Party committees are still expected to have an influence on a broad range of corporate matters. For this reason, annual shareholders' meetings in China have been found to be mostly ceremonial manifestations endorsing backdoor politics (Berkman, Cole, & Fu, 2010).

The discussion on the relative influence of Party committees and external government agencies overlooks the fact that many top executives in listed firms are involved in the Party hierarchy, whether they sit on the committee or not. A survey conducted in 2000 reveals that 69% of all directors on the boards of listed companies in China were appointed by the state or lower level organizations controlled by the state (Qiang, 2003). In essence, most appointments were steered by the political elite. State agencies could also intervene in the nomination process of key managers in top management teams, especially the CEO. The government therefore had substantial power to influence corporate objectives, sometimes intervening in transactions, and had a dominant voice amongst insiders to monitor the CEO's work, performance and allegiance (Tam, 2002). Similarly, The World Bank's Investment Climate Survey in 2003 found that 84% of CEOs of listed firms were Party members, 65% of which held official positions within the party hierarchy and 20% of which were hired directly by state agencies. The coding and calculations based on the original dataset used for the empirical section of the present study for 2129 listed firms in 2010 indicate that many top executives held formal Party positions outside their firm. In 21.3% of the firms, either the general manager or the board chairman held such a position. Also, 50% of the firms had at least one person among the senior management, the board of directors or the board of supervisors holding a Party position outside the firm. Among those firms, an average of 2.2 people had external political participation.

Brødsgaard (2012) observes that there is very little research about the role of the Party in human resources and appointment decisions in listed firms. Yet, as shown above by empirical evidence, many business managers are part of the Nomenklatura system of the Party. The Nomenklatura is defined as “a list containing those leading officials directly appointed by the Party as well as those officials about whom recommendations for appointment, release or transfer may be made by other bodies, but which require the Party’s approval” (Brødsgaard, 2012: 633). This is even more salient in the 53 largest SOEs (so-called national champions) where CEOs are still directly appointed by the Organizational Department of the Central Committee of the Chinese Communist Party (CCP) and have ministerial or vice-ministerial status. Most of these firms are among the 118 large corporations directly controlled by the SASAC, the central asset management commission of the State council. The Party thus has powerful leverages to orchestrate rotations of key

official between political and corporate positions. One of the government's incentives to prefer political connections among top officers is to ensure compliance with government policy. This is supported by the fact that private firms in China are more likely than SOEs to find legal loopholes, resist intervention and generally disregard the law in favor of their own business interests (Chan, Cheng, & Szeto, 2002). Brødsgaard (2012) uses the term *integrated fragmentation* to describe this mixed system of formal autonomy in corporate decision making and backstage political networks.

To sum up, informal political networks persist in China even in the private sector. Also, political control may take different forms, such as the SASAC at the central level. In this context, the degree of compliance to the new laws might differ across firms, generating a variety of forms of corporate governance. The assumption that only two dominant forms will emerge, one in the state sector and one in the private sector, overlooks the resilience of political influence. All of which points into the direction that the de facto corporate governance reflects not merely compliance with the new laws but the outcome of a negotiation between diverse stakeholders and their attempt to align their interests. Importantly, this raises the question of how these links to the Party influence the performance of listed firms.

2.3 Political Embeddedness and Firm Performance

In the Chinese context, nurturing a good relationship with the state and the political apparatus is often presented as a necessary condition for the survival of corporations. Yet, the literature on the impact of political connections and state involvement on firm performance is equivocal. This fuelled the popular State Capitalism debate which dominates today's discussion on state intervention (Krug, forthcoming). The two main views can be summarized using the *helping hand* and *grabbing hand* metaphor. The helping hand of the state can come through access to scarce resources, mitigation of policy uncertainty and close monitoring of management agency problems (Nee, 1992; Qian, 1995; Walder, 1995). From this perspective, the political leadership is assumed to have an incentive to enhance firm performance to obtain fiscal benefits (Wong, 1992). The grabbing hand assumes that

government officials have political priorities, are rent seeking, and attempt to maximize state revenue, including in ways that may diverge from the interests of shareholders (Shleifer & Vishny, 1994). In this scenario, the state dominates managers, thus limiting the influence of outsiders (Opper & Schwaag-Serger, 2008).

Looking at the improvement of corporate governance practices in Chinese listed firms, Nee et al. (2007) argue that while it is uncontested that the state played a role in the development of the Chinese economy, direct involvement in decision making produces negative effects at the firm level. On top of rent seeking behavior expected from any shareholder with sufficient decision making rights (Shleifer & Vishny, 1994), state officials can prioritize political objectives over maximizing returns, such as nurturing local job creation (Boardman & Vining, 1989; Sappington & Stiglitz, 1987; see also Blanchard & Aghion, 1996; Hellman & Schankerman, 2000). The over-employment problem of state firms (and employee owned firms) is more severe in labor intensive industries (Aguilera et al., 2008).

In the specific case of SOEs, problems stemming from political embeddedness are two-fold. Firstly, the complete dominance of state representatives in the decision making process “guarantees close cooperation and communication ties” with management and supervisors, ensuring that “private shareholders have virtually no voice when it comes to crucial company decisions such as the selection of CEOs, and the nomination of members of the supervisory board” (Opper & Schwaag-Serger, 2008: 255). Secondly, the lack of a unity of command among state actors can lead to commitment problems. The case of large public utilities exemplifies problems of coordination between multiple state agencies and the ensuing lack of contractual commitment towards private firms that translates into opportunistic ex-post renegotiation and potential state capture (Krug, 2012). Yet, not all state firms are equal. Wang et al. (2012) consider SASAC as a sort of mid-range institutional investor that, although tightly connected to the Party, enjoys a reasonable level of autonomy and unity of command. They demonstrate that shareholding by the SASAC and its subsidiaries has a positive effect of firm profitability compared to traditional state ownership, but still a lower positive effect than private shareholding.

These adverse effects do not only follow the ownership rights of the state, but also the decision making rights secured through ties with the Party even in private firms. Fan et al.

(2007) find that, during the first three years after their IPO, firms headed by politically connected CEOs display lower stock returns, sales growth and earnings growth. Their board also contains more directors with bureaucratic and political backgrounds. Similarly, Nee et al.'s (2007) results show that involvement of party committees and of administrative agencies in decision making have a negative impact on firm performance.

On the other hand, Guthrie and Slocum (2010) argue that the Chinese experience, exemplified by PetroChina and other successful public-private partnerships such as the China-Singapore Suzhou Industrial Park Development Co., challenges the long held Western assumption that entities owned by or closely connected to the state are inherently less efficient than private initiatives (Kornai, 1980; Sachs, 1992). Chinese institutional innovations call for “more theoretical research on how and the conditions under which state ownership might lead to efficient outcomes” (Guthrie & Slocum, 2010: 307).

Indeed, political embeddedness can generate positive outcomes for market players, partly or fully offsetting the negative effects of rent seeking and political objectives on performance. As an example, Krug (2012) uses the case of TVEs to demonstrate that political agencies are often not mere agents relaying the central leadership's preferences but instead become active market players that support market thickness and effective coordination. The local nature of embeddedness in TVEs facilitates coordination through trust and tradition. Also, ties to the state can provide access to capital and administrative resources. The involvement of the state can be of great value for a firm in an institutional framework characterized by controlled resource allocation and administrative monopoly. Firms in the state sector in China have access to cheap and abundant capital through the large state-owned banks since local government officials can influence loan attributions (Park & Sehart, 2001). Administrative approvals and procedures for market entry can also be eased when managers are connected to government officials. Furthermore, pressure from local Party committees on controlling shareholders has been found to restrain expropriation of the firm's cash-flow (Chang & Wong, 2004). Peng and Luo (2000) demonstrate empirically that managerial ties with government officials have a highly significant and positive impact on a firm's market share and profitability.

The fact that political connections can provide alternative means of financing has also been demonstrated in other countries. In the case of Indonesia for instance, Leuz and Oberholzer-Gee (2006) find that politically connected firms are much less likely to seek foreign capital than other firms, suggesting that political connections and foreign capital are substitutes. However, a change of political regime alters their privileged access to finance through their former connections, initially leading to under-performance until firms successfully attract foreign capital. In China, the stability of the political regime effectively eliminates the threat of regime change on the privileges of connected firms.

Thus, the empirical evidence at the firm level is mixed on whether political connections (political capital) in transition economies are beneficial (helping hand) or detrimental (grabbing hand). The impact of state ownership, whether partial or with controlling stakes, can be negative to firm performance (Fan et al., 2007), but political capital can also have a positive effect (Peng & Luo, 2000). Even in the field, based on in depth interviews, Nee and Opper (2012) found two types of Chinese entrepreneurs: some perceive that political agents cannot bring much to the table and therefore refuse to play the political game, and others rate their political ties as a crucial asset. In essence, there is no consensus on whether and which kind of state involvement works to the benefit or detriment of firm performance and ultimately market development. As the State Capitalism debate demonstrates, new empirical approaches clarifying the different consequences of state interference at the firm level are needed to get a clearer and more nuanced view of the corporate governance and ultimately economic performance of firms (Krug, forthcoming). This requires an analysis of how features of political embeddedness are integrated to and interact with the corporate governance structures implemented by firms. The next section provides the building blocks for such an analysis by reviewing the two main ideal-type systems identified in the literature, which serve as starting points for the exploratory empirical study.

3 CORPORATE GOVERNANCE

3.1 Competing Models of Corporate Governance

When it is assumed as discussed above that the new laws concerning firms and their operational environment must lead to heterogeneity of corporate governance in China then the question remains how to differentiate between the different forms. The literature on comparative corporate governance offers a valuable starting point by identifying the main ideal type systems, the features of which are useful building blocks to determine the corporate governance practices to be used in the exploratory study. The approach is grounded in the dichotomy between insider control systems and outsider control systems, which was first advanced by Jenkinson and Mayer (1992), and Franks and Mayer (1997) and more recently synthesized by Garcia-Castro et al. (2013). Generally, outsider control systems aim to maximize shareholder value through board independence, high disclosure, dispersed ownership, a market for corporate control, strict rules of anti-self-dealing and the absence of a two-tier board. Insider control systems rely on a two-tier board as broker between stakeholders, including banks and employees, and exhibit highly concentrated ownership. In China as in most transition economies control and the allocation of decision making rights superimposes the ownership question. An exploration of the impact of political embeddedness on these models is thus also presented below.

Corporate governance was not the first international comparative research agenda to value firm level analysis. Hall and Soskice's (2001: 6) theory on varieties of capitalism "regards companies as the crucial actors in a political economy". It therefore seems particularly relevant to use insights from the comparative corporate governance literature to inform a study of firm level configurations. In their seminal theoretical analysis of the cross-national diversity of corporate governance, Aguilera and Jackson (2003) identify three dimensions that define the relations that capital providers entertain with the firm: financial VS strategic interests, commitment VS liquidity, and debt VS equity. In turn, these dimensions are influenced by three institutional domains: whether property rights favor small or large shareholders, whether the financial system is bank- or market-based, and whether inter-firm networks exhibit relationships multiplexity (Aguilera & Jackson, 2003). These terms help

characterizing the various typologies and models of corporate governance observable around the world.

Insider control system. Liu (2006b: 418) describes the dominant or typical corporate governance system observed in Chinese firms as a control-based model, which involves a “concentrated ownership structure, management-friendly boards, inadequate financial disclosure and inactive take-over markets”. The label “control” in this context should be understood as an insider-control system, also called insider-dominated model in Kim and Lee’s (2012) account of South Korean firms. Large block holders use internal monitoring mechanisms to discipline management (Aguilera & Jackson, 2010). Insider control systems typically rely on a strong supervisory board to balance the interests of powerful and informed stakeholders, like banks and employees, that play an active role in the governance structure and decision making process (Franks & Mayer, 1997). The complementarities between employee participation in decision making and a strong relationship with banks are exemplified by the Japanese case (Aoki, 2001, 2007). Such brokerage of interests between stakeholders is also necessary when corporate shareholders have a supplier-customer relationship or other forms of strong ties such as mutual cross-shareholding. These inter-firm networks refer to the multiplexity of relationships between firms. A tight web of stakeholders compels firms to favor long term commitment over exit options (Aguilera & Jackson, 2003). The Chinese market is known for the volume of related party transactions (Young et al., 2008), implying the presence of substantial multiplexity and suggesting a preference for commitment as the control mechanism. In a similar fashion, because Chinese firms are often politically embedded, the Party is positioned as a powerful and informed stakeholder.

Insider-control systems are likely to prevail when property rights, referring to the legal and formal allocation of decision making rights, are less clearly defined (Aguilera & Jackson, 2003). Where shareholder rights favor large investors, strategic interests and control via commitment tend to dominate. The Japanese system, which uses majority principles in voting rights and mandates little information disclosure, and the German system, which grants disproportionate power to block holders through the institution of two tier boards, both favor commitment and strategic interests. Such systems also typically rely on bank

based rather than equity market based systems (Aguilera & Jackson, 2003). In fact, strong ties with financial institutions can undermine the market for corporate control (Aoki, 1994; Baums, 1993). Banks convert household savings into investments using debt and rely on longer term relationships, which reinforce the commitment to internal monitoring. Owners are thus expected to display a high level of commitment instead of relying on market liquidity (exit options) as a control mechanism and prefer bank loans as a means of financing (Aguilera & Jackson, 2003). They also prefer a long term strategic orientation (Aguilera et al., 2008), which allows to pursue non-financial objectives such as gaining access to resources. As mentioned in the previous sections, state ownership in China may fall squarely into this category.

Finally, the opportunity cost of information disclosure is also higher when a block-holder has a majority stake, since strategic decision making is ultimately not shared (Aguilera et al., 2008). For instance, family firms have concentrated ownership and their internal control is steered by insiders with strong commitment to long term strategic interests (Dhnadirek & Tang, 2003). Such a tight kin network of insiders is typically reluctant to disclose strategic information to outsiders. Information disclosure is not a good fit with insider-dominated firms, since it is not complementary with concentrated ownership and internal control, especially in weak legal environments. The same preference is expected to prevail in highly politically connected firms. Yet, “state block holders may also require transparency to avoid claims of unfair competition in international markets” (Aguilera et al., 2008: 486). So SOEs might be forced against their will to provide high disclosure.

Outsider control system. The outsider-control system, which has also been labelled the standard shareholder-oriented model (Hansmann & Kraakman, 2001), rests on the primacy of shareholders in widely held corporations over other stakeholders. In such systems, thicker liquid markets can support a diversification strategy that allows for flatter ownership structures and securitized debt (obligations). Individual investors prioritize cash flow maximization and institutional investors, often dominated by pension funds, play an important role to diversify and maximize the financial interests of their investors (Aguilera & Jackson, 2003). Management discipline stems from liquidity and the market for corporate control because each individual shareholder, having diversified assets across firms to

manage risks, has little incentive to invest resources in monitoring activities (Aguilera & Jackson, 2010). In turn, this market for corporate control is highly dependent on high information disclosure and effective deterrence of insider trading (Franks & Mayer, 1997). So financial interests and market liquidity are predominant where the shareholder rights of small investors are legally well protected (Aguilera & Jackson, 2003). These laws are usually accompanied by strong anti-trust regulations that prevent extensive multiplexity.

The governance structures in outsider-control systems do not only rely on the investor's exit option to discipline management. Shareholders rights are also meant to guarantee that investors can participate in the governance structure and voice their interests. For this purpose, a unitary board consisting of independent directors should monitor the firm to ensure shareholder wealth maximization (Franks & Mayer, 1997). The annual shareholder's meeting should also allow minority investors to put forward proposals and nominate directors to the board. The textbook example of outsider-control systems is the Anglo-Saxon model used in the United States and the United Kingdom (Aguilera & Jackson, 2003). In this model, executive incentives meant to align the interests of managers with those of shareholders are complementary with board independence and the market for corporate control. In turn, this combination is only effective with information disclosure and rigorous auditing. Indeed, for a firm that relies on equity markets to raise capital, especially with foreign investors, the benefits of information disclosure related to greater transparency with potential shareholders outweigh the costs (Goyer, 2003).

There is evidence to suggest that the practices transplanted from the outsider-control system can be successful in the Chinese context. Liu (2006b: 418) demonstrates that companies that rely on features that diverge from the dominant control-based model, such as "dispersed ownership, active take-over market, independent board, high level of information disclosure and institutional investors", are more likely to make decisions in the interest of minority shareholders, have better accounting standards, and provide higher stock returns.

3.2 Domestic Heterogeneity of Corporate Governance Configurations

It is generally assumed that national models will tilt towards one of the two ideal type systems described above. This section presents a stream of literature that argues that more than one model can cohabitate within a single jurisdiction and that recognizing domestic heterogeneity requires the conceptualization of corporate governance forms as open systems in which practices interact with institutional contingencies. Indeed, recent developments in research stress the need to endogenize a broader range of factors when explaining the emergence and persistence of different forms of corporate governance. In this regard, China poses a challenge to conventional economic theory. Despite weak legal institutions, a thin financial market and environmental uncertainty, private businesses have been growing steadily. In other words, “despite the absence of formal private property rights, Chinese entrepreneurs have felt sufficiently secure to make large investments, making that country by far the world's fastest growing economy over the last two decades.” (Rodrik, Subramanian, & Trebbi, 2004: 157) Yet, while China has defied predictions of classical economic theory, nothing suggests that standard economic concepts don't apply in China. John Child (1994: 301) explains that “the conceptual tools for analyzing organizational fundamentals such as authority, control, structures of governance, normative systems, property rights, [...] supply the bricks from which a reasonably adequate representation of the Chinese case can be constructed”. The Chinese experience might just call for more subtle adaptation to the local context. A contextualized approach conceives of institutions as influencing the interests and identities of actors (Aguilera & Jackson, 2010). Aguilera and Jackson (2003) propose that the specific roles played by capital, management and labor and the interactions among them are shaped by institutional configurations. Their idea rely on the assumptions that different types of investors (banks, families, funds, state, etc.) and different managerial cultures result in different interests and that relations among actors are socially embedded rather than isolated from the institutional context (Dacin, Ventresca, & Beal, 1999).

Firstly, the institutional context is itself shaped by relations among actors. Since the meaning of law is often negotiated in the marketplace (Dobbin & Sutton, 1998; Edelman & Suchman, 1997), the implementation of new norms and practices is often the theatre for power

confrontations between interest groups. While the rule of law has long been conceived as a prerequisite for the rise of functioning markets, new insights suggest that effective legal frameworks only rise in “response to a failing self-enforcement mechanism” (Krug, 2012: 357; see also Dixit, 2007). However, the proper implementation and enforcement of laws, even when they are desired by market players to palliate failing informal institutions, can be hampered by political embeddedness. For instance, the usage of the enterprise bankruptcy law in China is limited by a lack of cohesion in the state administration regarding its implementation, which leads to ambiguity in its application and a general preference to settle disputes outside courts in processes that are subject to political agents' interference and discretion (Krug, 2012). Political embeddedness can thus be a force for path dependence by limiting the usage of law.

Secondly, the economic actors and the relations among them are shaped by the institutional context. Shareholders across jurisdictions might not fit the same ideal type (Aguilera & Jackson, 2010). While the need for any investing party to gain sufficient assurances that the terms agreed upon regarding decision making rights, income rights and exit options is present in all contexts, the mechanisms used to achieve a sufficient level of protection might differ in an environment characterized by weak legal institutions and high uncertainty. In other words, distinct mechanisms can be functional equivalents, or substitutes. The concept of substitution is expressed clearly in Ahlring and Deakin's (2007: 872) comparative study of international systems: “by virtue of functional continuity, in addition to observing complementarities within national systems, we are likely to observe functional substitutes or equivalents -institutions that substitute for one another in the sense of performing a similar function in different ways- across systems”. Actors in different systems therefore have different legal and institutional tools at their disposal to structure their relations.

This is also the case at the national level, where a diversity of equally successful practices and organizational forms can emerge. Scholars are increasingly aware of the richness of the variety of effective institutions in local marketplaces (Krug & Hendrischke, 2012; Meyer et al., 2009; Peng et al., 2008). Whitley (2006: 192) stresses that “not all states can be expected to establish a single kind of business system throughout all regions and sectors of an economy” and that “the nature of firms, their strategies, and capabilities frequently vary

between sectors, technological regimes, and regions within countries”. Consistent with Whitley’s view of organizational heterogeneity, and following a tradition that recognizes the decentralized nature of property transformation in transition economies (Stark, 1996), organizational level analyzes promises to best explain the nature of market institutions that are effectively used in the realm of corporate governance.

The typical approach of corporate governance studies to examine practices in silo is ill-fitted to the analysis of functional equivalents. While some elements can be individually beneficial, another stream of literature conceives corporate governance rather as a configuration of multiple interdependent practices that maintain internal coherence as a system (Beatty & Zajac, 1994; Davis & Useem, 2002). New insights from the comparative corporate governance literature emphasize the need for an *open systems* perspective, taking environmental contingencies into account in addition to internal complementarities. For long, research on the effectiveness of corporate governance has mostly paid attention to internal factors, such as practices and structures that allocate decision making rights within the firm and among key stakeholders. Aguilera et al. (2008) propose that a richer understanding of corporate governance should incorporate an open system approach, in which organizational practices and structures are inherently interdependent with the environmental context. Such an approach allows, as opposed to closed system approaches such as agency or stakeholder theories, to “uncover the diversity of arrangements and to understand how the effectiveness of governance practices is mediated by their fit or alignment with situational variables (context) arising in diverse organizational environments.” (Aguilera et al., 2008: 476).

The open systems approach provides an insightful framework to analyze the patterned variation of outcomes emerging from interdependencies between the external context and internal practices in different types of firms. Aguilera et al. (2008) characterize this fit of practices with the institutional and competitive environment as the contingencies. These should be analyzed simultaneously with internal complementarities, which assume that some governance practices cannot be implemented in silo but rather become effective only in conjunction with other practices or structures. Finally, the opportunity costs of implementation and the benefits of a given practice will vary across environments. Taking

into account different configurations of practices within organizations and the subtle environmental contingencies surrounding them is necessary to flesh out the domestic diversity of forms of corporate governance. For the purpose of the present study, to bring context to the analysis as suggested in the literature asks for the identification of China-specific factors and how those factors might complement or supplement features of the ideal type systems of corporate governance.

3.3 Corporate Governance Models “With Chinese Characteristics”

This section explores how ideal type systems of corporate governance may apply in conjunction with China specific factors primarily embodied in the presence of inherited features of strict political governance. To this end, a discussion of how the Chinese market structure differs from western contexts offers a relevant starting point. Roe (1994) has argued that the US equity market is particularly healthy in terms of liquidity and dispersed ownership because banks were heavily regulated for the large part of the industrial revolution, and therefore unable to develop the tight relationships with non-financial corporations that their European peers enjoyed (see also Aguilera & Jackson, 2010). This national-level governance dimension of bank-based and market-based systems cannot be easily applied to China. In China, the equity market is under-developed and the banking resources are steered predominantly towards firms in the state-sector or those that are politically connected. Capital at early stages is provided by the individual networks of entrepreneurs who channel by themselves the savings of their family, colleagues or friends (Nee & Opper, 2012). More mature firms rely in large part on organic capital generation for reinvestment. Without accounting for heavy hybridization, none of the two ideal-type systems are observable in China. Of course, internal capital generation is also the most important source in market- and bank-based systems (Corbett & Jenkinson, 1996). Still, the marginal capital obtained either from loans or external shareholders are often critical in growth management. Also, it is important to note that no system produces uniformity at the firm level. Many American firms have large banking liabilities while many German firms don't (Rajan & Zingales, 1995), which suggests that firms leverage all the sources of funding at their disposal. Aguilera and Jackson (2010: 499) contend that “the more robust differences

lie in the forms of monitoring associated with these financial systems and their impact on the distribution of rewards in corporate governance”. In a transition economy like China, the discussion about income and decision making rights allocation that is crucial to monitoring must take into account the enduring role of the state. This section offers insights from the literature on how political embeddedness and state control may affect the prevalence and efficiency of corporate governance models.

In countries where CEOs are subject to more political pressures, concentrated ownership prevails as a mechanism to control for this added agency problem (Roe, 2000). For instance, in social democratic European countries more pressures are exerted by governments on business managers than in Anglo-Saxon countries for community purposes such as employment stabilization and investment promotion. In such countries, to control the additional agency costs incurred because of state pressures, concentrated ownership persists as an effective governance mechanism instead of typical internal and external corporate governance practices put forward in markets with low government intervention (Roe, 2000). Indeed, low public pressures allow for dispersed ownership, accompanied by a norm of shareholder wealth maximization as the duty of managers as well as internal (incentive compensation, accounting transparency, board independence) and external (market for hostile takeovers) corporate governance mechanisms to solve principal agent problems. In markets with high ownership concentration, the CEOs have been found to enjoy much less managerial discretion and less influence on business outcomes than in markets with dispersed ownership (Crossland & Hambrick, 2007). At a systemic level, these insights suggest that political embeddedness has inherent complementarities with ownership concentration rather than dispersion.

Firm level studies in China seem to support the fact that ownership dispersion is not complementary with political embeddedness. While Roe (2000) suggests that political pressure is a determinant of the ownership structure, Wong et al. (2004) find the reversed relation: shareholder structure of Chinese listed firms influences the level of politicization. Firstly, the proportion of individual shareholders is negatively related with the Party's decision making power in the firm. They interpret this result as an indication that the presence of individual investors that can exercise their exit option leads to *direct*

depoliticization. Secondly, the presence of large institutional investors attenuates the negative relationship between political influence and firm performance, which shows that external shareholders with a strong voice are a force for *indirect depoliticization*. This kind of study is difficult to reproduce with data from recent years because the split share reform has made it difficult to track shareholder identity in aggregate numbers. In sum, while they disagree on the direction of causality, both Roe (2000) and Wong et al.'s (2004) concur that political embeddedness is complementary with concentrated ownership.

In turn, this confirms that political embeddedness is expected to be complementary with an insider-control system rather than an outsider-control system. For Hansmann and Kraakman (2012: 34), China today is a perfect example of “state-oriented model”, much like Japan in the 1960s or South Korea in the 1970s. This type of governance has elsewhere been labelled “administrative governance” (Pistor & Xu, 2005: 185). In this respect, strong political connections negatively affect the effectiveness of Western-style board-level corporate governance practices (Yang et al., 2011). For instance, Goyer (2003) finds that information disclosure is complementary with dispersed ownership, foreign and institutional investors and the absence of family or political control. Similarly, the contamination of performance evaluation of managers in Chinese SOEs by political objectives is expected to reduce the effect of compensation packages on incentive alignment (Yang et al., 2011). Even if one accepts the agency theory assumption that managers are primarily driven by self-interest and extrinsic reward, incentive compensation may still only have a marginal effect on the motivation of managers. Their potential career improvements are tied to performance assessments that also rely on criteria foreign to the agency theory framework and embedded in the political priorities of state agencies. These priorities and career advancement mechanisms are known by Chinese investors. Incentive compensation in state firms should therefore not be expected to have a strong effect on incentive alignment, or to reduce the cost of capital. This may also be true with political connections. Aoki (2001) suggests that the effectiveness of incentive compensation to align managers' interests to those of the shareholders is lower when other powerful stakeholders have close-knit long term relationships with the firm. This has been observed in countries such as Germany and Japan that rely on a bank-based financial system and where employees participate more actively

in corporate decision making. In China, the monitoring role of the Party as a stakeholder is expected to produce a similar outcome.

Yet, while political connections hinder the effectiveness of Western-style corporate governance practices, these same political ties have sometimes been found to be effective functional equivalents. For instance, political appointment of CEOs in China may reduce principal-agent problems. Li and Tang (2010) indeed show that the impact of CEO hubris, defined as exaggerated pride or optimistic overconfidence (Kahneman & Tversky, 1995), on firm risk taking in Chinese manufacturing firms is increased by managerial discretion, while it is decreased if positions of BOD Chairman and CEO are held by different people or if the CEO is politically appointed. This suggests that the shadow of political governance can be a substitute to effective board monitoring to reduce the salience of mismanagement in the form of miscalculated risk taking. La Porta, Lopez-De-Silanes, Shleifer and Vishny (2000) had also found that poor investor protection can be offset by social embeddedness. In countries with poor investment protection, firms are often held by the founding family. This social embeddedness in family ties can provide sufficiently strong ex-ante commitments to compensate for weak formal institutions. As exposed earlier, tight political networks can provide similar embeddedness to align the interests of insiders. Still, while concentrated ownership allows the controlling owner to monitor managerial agency and political pressures (Roe, 2000), minority shareholders are left defenseless against expropriation of their rightful cash flow by controlling shareholders. In short, features of political embeddedness salient in China are naturally more complementary with an insider-control system than an outsider control system. Political connections may even act as an effective surrogate to the functions of practices associated with outsider-control. Given these subtle interactions and following on the expectation of heterogeneity discussed in the previous section, one model or the other will not uniformly and integrally prevail among firms. The following section explores the theoretical underpinnings of the process recombination that result in the firms adopting innovative sets of practices that fit their context and that may diverge from ideal type models.

3.4 Hybridization: Corporate Governance Configurations

The aforementioned analysis suggests three forms of corporate governance. On one side is a form that, in the Chinese case, adheres to the new laws formulated according to Western standards and aiming at outside control by shareholders and investors. On the other side are two forms (politically embedded or private insider control) that both revolve around strong insider control with a predominant shareholder that, given the political control inherited from the past, may or may not have strong ties to the political apparatus (party members or state administration). The benefits of politically embedded firms and the informal political networks, empowered by local autonomy, allow firms playing with different forms of corporate governance. These in-between forms often called hybrids ask for a more nuanced analysis as the term hybrid suggests an inferior form and/or a transitory phenomenon. Instead, the term configuration is adopted to allow for the inclusion of components of each or any of the theoretically defined forms.

Firstly, it should be noted that the models presented above are not immutable. In fact, the observed reality often departs from theorized ideal types. For instance, in theory, dispersed ownership is contingent upon strong shareholder's rights. Weak shareholder rights lead to a concentration of ownership because investors need larger stakes to exert internal control on managers (La Porta et al., 2000; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Minority shareholders face higher risks and are more reluctant to buy shares unless at a discount, which provides lower incentives for firms to conduct share emissions in the first place. However, La Porta et al.'s (2000) main claim that shareholder rights are a potent predictors of patterns in ownership concentration across countries has been criticized. Aguilera and Jackson (2010) explain that strong protection of minority investors is not a necessary condition for ownership dispersion, as confirmed by the cases of Switzerland and Ireland where relatively weaker shareholder rights are not accompanied by significantly higher ownership concentration. Similarly, they are not sufficient conditions, since countries with strong protections like Spain and Portugal still exhibit large block holders. So in practice, strong shareholder's rights do not appear to constitute a necessary or a sufficient condition for ownership dispersion. Also, Coffee (2005: 207) challenges the claimed superiority of dispersed ownership, as advanced by the legal origin literature, showing that

while concentrated ownership leads to a lack of transparency regarding the appropriation of private benefits, “dispersed ownership is vulnerable to gatekeepers not detecting inflated earnings”. The complementarities that conceptually bind the various elements of each model do not constitute universal laws.

Secondly, it is important to note that fully fledged governance models do not appear in a vacuum. Streeck’s (2001) work is helpful to understand the subtlety and spontaneity of the emergence of coherent systems. Complementarity is discovered rather than planned, emerging through experimentation and hybridization out of a pool of elements that were not necessarily compatible from the onset. As stated earlier, coherent systems involve internal complementarities that must fit the firm’s environmental contingencies (Aguilera et al., 2008). Bottom-up organizational change and top-down institutional reforms both matter. It is unlikely that the elements at all levels can transition simultaneously from one coherent model, say politically embedded insider-control system, to another coherent system, such as a market-based outsider control system. On the one hand, the costs of giving up on the complementarities with the surrounding consistent system and the isomorphic pressures from the environment can deter firms from radical change. On the other hand, the state is also experimenting with institutional reforms in a way that minimizes system wide disruptions. Such a process of fuzzy institution building, often steered by the elite, typically happens during exceptional political moments. Yet, the resulting coherent systems must “be continuously established, restored, redefined and defended against all sorts of disorganizing forces” (Streeck, 2001: 30).

The corporatization of the state sector in China certainly represents one of those exceptional political moments. Victor Nee (1992: 2) had already found in the 1990s that transition economies have “given birth to a new diversity in organizational forms and a plurality of property rights.” The rapid evolution of the market environment gave rise to hybrid forms of firms whereas, for instance, the management of small public enterprises is leased to private operators. Nee claims that hybrid forms of enterprises persist where property rights are less defined (messy). According to Boisot and Child (1996), such hybrid forms include marketized state enterprises. Krug (2012: 348) remarks that “if political embeddedness results in functioning markets then we cannot expect political embeddedness to be only of a

transitory nature”. In other words, where the state has a helping rather than a grabbing hand, political interference and state control would remain a lasting institutional feature, possibly as one element of new hybrid configurations of corporate governance.

Such hybridization has been observed in other countries. A good example to illustrate the dynamics of hybridization in corporate governance and the role of complementarities is the German case (Höpner, 2005). Two external pressures resulting from internationalization were instrumental to the rise of the shareholder value orientation in large German corporations: the increased competition in export-oriented industries following European integration, and the rise of domestic and foreign institutional investors that accompanied the appearance of hostile takeovers (ex: Mannesmann/Vodafone). The institutions of co-determination (employee participation) and two-tier board were not dismantled as a result of the new shareholder value orientation, but instead reinforced through an unlikely alliance between labor and capital to pressure management for more information disclosure. Dominant in Chile and Malaysia as well, this kind of alliance has been labelled the *transparency coalition* and has been found to fuel the dispersion of share ownership (Aguilera & Jackson, 2010; Gourevitch & Shinn, 2005). These case may not apply to China, but they demonstrate that elements pertaining to theoretically competing models can be recombined and display unexpected complementarities.

The previous section has presented how the concept of political embeddedness applies to China and how features of political governance have persisted during a wave of market reforms and standardization of corporate governance structures. The present section has provided the conceptual building blocks necessary to distinguish competing models of corporate governance, namely the outsider-control system and the insider-control system, as well as a discussion about the potential interactions between political connections and elements of these two ideal type models. It also explored the dynamics that can produce domestic heterogeneity of corporate governance forms and instances of hybridization involving the recombination of seemingly incompatible practices. The remainder of this chapter endeavors to devise and implement an inductive exploratory empirical study that aims to identify and characterize the main corporate governance configurations that have

allowed listed firms to achieve performance in a context of institutional tensions between inherited institutions of political governance and a recent wave of market oriented reforms.

4 EMPIRICAL ANALYSIS

4.1 Data and Sample

This section describes the design of the empirical study of large samples of listed firms in China used to analyze the heterogeneity of forms of corporate governance and the effects of political embeddedness on firm performance. Given their distinct institutional background, private firms and state-owned enterprises are separated into two distinct samples. Besides the multiplicity of objectives in decision making of SOEs discussed in section two of the present chapter, SOEs and private firms are subject to distinct institutional constraints in many areas, for instance regarding their treatment during internationalization both in the home country (Liang, Ren, & Sun, 2015) and host country (Meyer, Ding, Li, & Zhang, 2014), concerning issues and perceptions of corruption (Nguyen & van Dijk, 2012) or patterns of earnings management (Ding et al., 2007). Using separate samples also allows understanding the distinct role of political embeddedness in each institutional setting. In addition, corporate governance in SOEs being under-studied in the literature, the production of dedicated results provides an opportunity to single out findings that specifically concern SOEs. Indeed, compared to the large body of literature on corporate governance in private firms, there is little research on corporate governance in SOEs and its differences with private firms apart from the general and largely unhelpful claim that corporate governance in SOEs is relatively inefficient (Dilova-Kirkowa, 1999; Mahadeo & Soobaroyen, 2012; Sokol, 2010). This is even more relevant for the case of China since the listed SOEs included in this study have been marketized. Most studies of SOEs concern firms that are wholly owned by the state, while many SOEs especially in transition economies have been corporatized by floating shares on stock markets and allowing minority block holdings by private investors, which can enhance firm performance (Aivazian, Ge, & Qiu, 2005; Berkman, Cole, & Fu, 2014), but also weaken the legal regime of investor protection (Pargendler, 2012). The corporate governance structure of corporatized SOEs can differ substantially from the internal government-led monitoring mechanisms observed in

traditional SOEs as they are subject to market forces and outsider scrutiny. Finally, in terms of research design, although 8 out of 9 explanatory conditions used in the empirical analysis are the same across the two samples, separating in two samples allows the inclusion of a 9th condition that is specific to each sample and that could not apply to the other sample (these specific conditions are discussed below: type of state ownership in the SOE sample and participation measures during the shareholders meeting in the sample of private firms).

The working definition of state-owned enterprises employed in this study is exhaustive, going beyond the immediate owner and coding as SOE any firm that is ultimately owned by a state agency at any level, or owned by an entity managed by a state organ, or any firm for which the largest shareholder corresponds to these criteria. To do this, ownership data is cross-checked from three databases (Orbis, GTA information and Sinofin) and triangulated using company websites and annual reports in cases of inconsistent information. The samples exclude cases with incomplete data, such as firms that had their IPO over the course of the year. To ensure the comparability of the two samples, the dataset also excludes industries in which SOEs represented less than 30% of firms or more than 70% of firms. This reduces the potential comparative distortion to measures of performance stemming from the over- or under-representation of state firms. Five industries were thus excluded: timber and furnishing, finance and insurance, mining, utilities and transportation. The final samples included 810 SOEs and 942 private firms. All the data is collected for the year 2010, which is selected to adequately balance recency and completeness of the dataset.

4.2 Method

To decipher interconnected elements that have complex causal relationships with an outcome, configuration analysis seemed the most suited method. Fiss (2007) retains Meyer, Tsui and Hinings' (1993: 1175) definition of organizational configurations as “any multidimensional constellation of conceptually distinct characteristics that commonly occur together”. This view assumes that organizational structures and practices cannot be analyzed in silo but rather as a coherent set of complementary and interconnected elements. As explained below, configurational analysis allows for ingrained study of complex causal

relationships that involve non-linearity, multivariate interaction effects, or asymmetry. A powerful application of this method is the examination of equifinality, which refers to the possibility that "a system can reach the same final state, from different initial conditions and by a variety of different paths" (Katz & Kahn, 1978: 30). In essence, distinct sets of practices and structures can lead to the same outcome. Within the concept of equifinality lies the idea of asymmetry, whereby a condition might lead to a particular outcome when combined with a given set of complementary conditions while the absence or the opposite of the same condition may also lead to the same outcome when combined with a different set of conditions (Ragin, 2008a). By extension, this means that configurational methods are useful to analyze non-linear causal relations since the results do not attribute an overall sign to the effect but rather identifies the absence and presence of the conditions in each configuration separately (Fiss, 2011). This is especially suited to study the heterogeneity of an organizational landscape.

Fiss (2007: 1181) explains that set theoretic methods are particularly suited to study the multivariate interaction effects of organizational configurations since they "do not disaggregate cases into independent, analytically separate aspects but, instead, treat configurations as different types of cases". Econometric approaches are more powerful to analyze additive effects *ceteris paribus*, while set theoretic methods make use of Boolean algebra to attribute an effect to both the presence and absence of complementary factors. Traditional interaction effects in statistics can capture some synergies, but are ambiguous to interpret beyond typical bi-variate interactions. Another alternative method to study configurations is cluster analysis (Lim, Acito, & Rusetski, 2006). However, while this method is useful to discover the co-occurrence of characteristics across similar cases, it does not emphasize the causal factors that are central to configurations. Because of this, cases that share few but important causal factors while differing on many other characteristics would be attributed to different clusters, while still pertaining to the same causal sets (Fiss, 2007).

The configuration analysis is operationalized using the fsQCA software (Ragin et al., 2006), which relies on set theories and Boolean algebra. While Boolean algebra is initially built on binary variables (presence or absence of attributes) in what is called crisp sets, the use of fuzzy sets allows for ordinal and interval scale variables (Ragin, 2000, 2008a). The variables

are calibrated between zero and one, thus attributing a meaningful floor and ceiling (Ragin, 2008b). The method invites the researcher to use substantive knowledge about the cases and the causal relationships to calibrate the scales appropriately, instead of simply proportionately rescaling the continuous variable. In the present study, some conditions have custom scales while others (non-skewed interval scale variables) use the fsQCA calibration function. This form of data-driven calibration is commonly used in large-N QCA studies (Fiss, 2011; Greckhamer et al., 2008; Whittington et al., 2013). Also, in order to rely on scales that are not sample specific to calibrate the conditions and the outcome variable, the scales are anchored on the entire population of listed firms in China.

4.3 Outcome Measure: Firm Performance

When choosing a measure for performance, Chen, Li and Shapiro (2011) argue that accounting measures of operational performance such as the return on assets (ROA) are more informative and reliable than financial performance measures in China. Stock returns are less informative than in mature capital markets because the underdevelopment of Chinese stock exchanges, with a high proportion of shares that are not traded, high volatility (Lin & Swanson, 2008) and low transparency, hinders the price setting efficiency on the market (Peng, 2004). The ROA (ratio of net profits to total assets) is therefore adopted as the measure of performance for the outcome variable. Accordingly, the empirical analysis aims to identify the configurations of corporate governance that contribute to firm profitability (ROA). The measure is adjusted to the industry average to avoid noise from sector-specific factors. It is simply calculated by subtracting the average ROA in the industry from the firms ROA. The industry classification used is that of the China Securities Regulatory Commission. Finally, the calibration from 0 to 1 is done through the calibration function in the fsQCA software, which requires to set the thresholds for full-membership, full non-membership and the cut-off point, also known as the point of “maximum ambiguity” (Ragin, 2008b: 186). These thresholds are set at the 5th, 50th and 95th percentile of the industry-adjusted ROA from the entire population: -6.8%, -0.2% and 8.8%.

4.4 Explanatory Conditions

Nine explanatory conditions are used in each of the two analyses. To achieve maximum comparability, eight conditions are identical in the two samples. The ultimate condition differs because it was not applicable to the other sample. The selection of conditions was made with an aim to cover the most important factors identified in the literature, while also maintaining a parsimonious model to facilitate the interpretation of results. A model of nine conditions is below the maximum of 12 proposed by Greckhamer, Misangyi and Fiss (2013) for large-N fsQCA studies. The presentation of the conditions is followed a table (table 13) that provides descriptive statistics on the variables used for the calibration of each condition for the two samples separately.

Board independence. This is a typical component of Western systems of corporate governance, by which outsiders use voice within the board to protect the interests of minority investors. A custom scale for this item is established based on international standards. A score of 1 is attributed to firms with at least 50% independent directors, which was recommended in the Cadbury report in the UK and mandated by the New York stock exchange. A score of 0.75 is attributed to a score of more than 40%. A score of 0.51 (above the cut-off point) is attributed to firms going above the minimum requirements in China of one third. Firms meeting exactly the minimum are given 0.25. Firms under the legal threshold receive 0.

Proactive disclosure. Disclosure is an essential enabler of outsider influence mechanisms in the firm, in the forms of both internal control (voice) and external pressure (exit option). Two separate elements combine to produce an index of proactive disclosure, each worth 0.5. Firstly, firms are given a score on 0.5 depending on the delay of the release of their annual report. The number of days between year-end and release has been identified in past studies as an important feature of disclosure generally and in China specifically (Haw et al., 2006, 2000; McGee & Yuan, 2012; Park et al., 2013). In the US, the Securities and Exchange Commission (SEC) requires that the 10-k form (annual report handed to the SEC, not to the shareholders) be filed at different deadlines depending on the size of the company. The three thresholds used are 60 days, 75 days and 90 days. Despite the fact that deadlines differ per firm size, the thresholds are used for indicative purposes for the "proactive"

disclosure measure. Therefore, less than 60 days is worth 0.5. Less than 75 days is worth 0.35. Less than 90 days is worth 0.2. More than 90 days scores 0. Secondly, firms releasing quarterly profit forecasts, which is not mandatory but has been identified as crucial information by individual investors during exploratory interviews in Shanghai, are given an additional 0.5.

Management incentive. This is an important measure in the principal-agent model to discipline management and align interests with shareholders, especially under conditions of dispersed ownership. Tying manager's compensation to stock returns helps aligning their incentives on the interests of shareholders. Because information about incentive compensation is often incomplete and opaque in China, many authors have resorted to the basic share ownership of managers as a proxy for incentive alignment (Chen, 2001; Conyon & He, 2011; Gao & Kling, 2008; Li, Moshirian, Nguyen, & Tan, 2007). The measure adopted here uses a similar proxy, but takes the total market value of the shares at year-end instead of taking the simple quantity of shares. This translates more effectively the actual material incentives of managers. Because the distribution is highly skewed, the calibration follows a custom scale based on generic thresholds. More than 1 billion Yuan receives a score of 1. More than 100 million Yuan receives a score of 0.75. More than 1 million Yuan receives a score of 0.51. Less than 1 million Yuan receives a score of 0.25. 0 receives a score of 0.

Large minority. This condition is measured as the combined proportion of shares held by the second to the 10th largest shareholders. This measure has often been used in the Chinese context as a proxy for the market for corporate control (Liu, 2006b), which is an integral component of outsider external control. It has also been used as a proxy for internal checks and balances to prevent controlling owners from expropriating the cash-flow of minority investors through related party transactions or other means (Huyghebaert & Wang, 2012). The calibration employs the fsQCA calibration function based on thresholds set to the 5th, 50th and 95th percentile of the entire population: 3%, 20% and 48%.

Large controlling shareholder (SH). Where the law and internal governance mechanisms do not enable small investors to discipline management, concentrated ownership tends to persist. In insider-controlled firms, a large controlling shareholder can

discipline management through direct internal monitoring. However, while a large controlling owner can prevent principal-agent problems, it can expose minority investors to principal-principal problems (Claessens et al., 2002; Jiang et al., 2010). Following many other studies, the measure is calculated as the proportion of shares held by the largest shareholder. The fsQCA function is used to calibrate the condition according to the thresholds set at the 5th, 50th and 95th percentile of the entire population: 13.5%, 33.5% and 63.5%.

Supervisory board. An active supervisory board is emblematic of insider-control systems, where such a board serves to reconcile the interests of multiple stakeholders. While the presence of the board is mandatory in China, the frequency of meetings is used as a measure of the relative level of activity and a proxy of vigilance. The significance of meeting frequency as an important measure of board vigilance and good governance has primarily been demonstrated for boards of directors. Meeting frequency has been associated with lower levels of discretionary earnings management (Xie et al., 2003) and better board operations leading to higher performance (Vafeas, 1999; for the supervisory board see Jia, Ding, Li, & Wu, 2009). The condition is calibrated as follows. Holding 8 meetings or more per year gives a firm a score of 1. 7 meetings provide a score of 0.8. 6 meetings (at least bi-monthly) convert to a score of 0.6. 5 meetings convert to 0.4. 4 meetings convert to 0.2. 3 or less meetings convert to 0.

Political leadership. This is a binary condition that takes the value 1 if either the CEO or the board Chairman holds an official position for the CCP outside the firm. This is a strong feature of China's inherited system of central planning. Such measures of political connections firms' CEOs and presidents have been used in multiple studies (Faccio, 2006; Fan et al., 2007). The data was coded using the GTA corporate governance database on individuals in Chinese listed firms, which provides information on concurrent positions held outside the firm by directors, supervisors and top executives. An individual is coded as politically embedded if he held a political position within any organization (i.e. CCP committee member) or any position in a political organization (i.e. National People's Congress).

Political connections. This item is a second measure of political embeddedness. As opposed to the previous one which focuses on the leadership (CEO and board chairperson), this condition takes into account political involvement among all the top individuals. Top individuals here include every members of the board of directors, members of the board of supervisors and any other top executive whose profile is disclosed in the annual report. As stated in the previous sections, political embeddedness is expected to reduce the effectiveness of mechanisms based on the primacy of shareholders. In the literature reviewed for this article, no other study was found that measured the impact of political connections with such width including all top individuals in large samples of firms. For the calibration, a score of 1 is given for 4 or more connections, 0.75 is given for 2 or 3 connections, 0.51 is given for 1 connection, and 0 converts to 0.

Enabling shareholders' (SH) meeting. This condition is only used in the sample of private firms because it is widely acknowledged that, especially in SOEs, shareholder's meetings are nothing more than a ceremonial manifestation with no decision making power (Berkman et al., 2010). It measures the openness to outsider effective participation during shareholder's meetings to allow minority investors to voice their concerns and preferences and to monitor the board of directors. A firm obtains a score of 1 if it implements any or both of the following enabling measures during the official annual shareholder meeting: distance voting through electronic means, or cumulative voting. A score of 0.51 is given if any or both of these measures are implemented during an extraordinary shareholder meeting over the course of the year. Otherwise, the score is 0.

SASAC. The final condition only applies to the SOEs sample. It is a binary variable if the SOE is ultimately controlled by the central State-owned Assets Supervision and Administration Commission (SASAC) of the State Council or by an entity managed by it. Presumably, such firms would be more curtailed from political objectives and adopt a more rigorous shareholder value orientation.

Table 13. Descriptive statistics of variables used in the models for private firms and SOEs

	Private				SOE			
	Mean	Std.Dev	Min	Max	Mean	Std.Dev	Min	Max
Performance (ROA)	0.05	0.07	-0.54	0.71	0.04	0.07	-0.21	0.79
Proportion of independents on BOD Disclosure	0.37	0.05	0.20	0.60	0.37	0.06	0.25	0.80
Days to release of annual report	89	22	20	120	88	21	19	120
Release of quarterly profit forecast	0.55	b i n a r y			0.40	b i n a r y		
Management shareholding (mn RMB)	603	1366	0	27145	44	264	0	4087
Supervisory board meetings	5.24	1.79	1	15	4.87	1.52	1	13
Share of the largest shareholder	0.34	0.15	0.04	0.96	0.38	0.16	0.04	0.84
Share of the 2nd to 10th shareholder	0.26	0.14	0.01	0.66	0.17	0.12	0.01	0.61
Political leadership	0.13	b i n a r y			0.29	b i n a r y		
Political ties	0.53	0.85	0	5	1.54	1.85	0	12
Shareholder meeting*	0.53	b i n a r y						
Controlled by SASAC					0.27	b i n a r y		

* Takes value 1 if online voting and/or cumulative voting was used in any shareholder meeting.

4.5 Analysis

In the set theoretic approach, the first step involves the creation of a truth table that lists all the theoretically possible combinations of conditions. For a model involving nine conditions, there are 512 possible combinations. It should be noted that, while all combinations of characteristics can be studied conceptually, not all configurations are observed empirically. Some combinations might simply be impossible, and others just absent from the field. The absence of empirical observations for a configuration is called limited diversity (Ragin, 1987, 2000). Analyzing such absence of paths is relevant to explicit the incompatibility of attributes. Fiss (2007) also argues that identifying configurations that are close to the outcome set, but absent empirically, can provide ground for exploring new possible organizational designs. For each combination, the truth table displays the observed frequency, which is the number of cases that display this particular combination. It also provides the consistency, which generally represents the proportion of cases that are part of the outcome set.

The second step involves the selection of a minimum frequency threshold to eliminate combinations with too few cases and a minimum consistency cut-off to identify which configurations belong in the solution set. The frequency threshold must balance the need to avoid that cases become their own configuration in order to keep the solution to a manageable size, but to still allow a large proportion of cases in the analysis. While in small-N studies the frequency threshold is often set at 1 to include every case (ex: Meuer, 2014), in large-N studies, the rule of thumb is to set the threshold at a minimum of 3, while aiming to leave about 80% of the sample in the analysis (Greckhamer et al., 2013). For the consistency cut-off, a minimum of .75 (Ragin, 2008a, 2008b) or .8 (Fiss, 2011) is suggested, but studies have used cut-offs as high as .95 (Epstein et al., 2008). The consistency and frequency thresholds influence the overall coverage of a solution and its overall consistency. The coverage of a path (a combination of characteristics that produces the outcome) is the proportion of all cases that display this configuration among the membership set of the outcome variable (Ragin, 2006). Coverage therefore provides a measure of the relative importance of a particular path, interpreted in a comparable way as the explained R2 in statistics. In order to remove bias, a process of iteration helped choosing the frequency and consistency thresholds. A table documents the product of the overall coverage and overall consistency of the solution for every possible combination of frequency and consistency thresholds, changing the frequency by 1 and the consistency by 1%. In order to facilitate interpretation, solutions that contained 10 or more solutions were excluded. Given the large sample size, solutions that displayed an overall consistency of less than 85% were also excluded. The solution that maximized the product of the overall solution coverage and consistency indicated the frequency and consistency thresholds.

During the third and last step in the analysis, the truth table algorithm uses Boolean algebra to achieve logical reduction of statements according to their commonalities. The fsQCA software provides three separate outputs: the complex, the parsimonious and the intermediate solutions. Like in most other studies, the results presented below are based on the intermediate solution, which only uses plausible reduction assumptions drawn from the theory and inputted by the researcher. The resulting solution strikes a balance between interpretability and complexity, thus allowing analyzing core and peripheral causal conditions. Fiss (2011) introduces the use of fuzzy set analysis to uncover the core and

peripheral causal conditions within organizational configurations, identifying the characteristics that display strong and weak causal relationships with the outcome. His study refers to typologies of organizational design that can involve more than one marginally different, yet mostly similar, configurations. Fiss (2011) also introduces the concept of neutral permutations to describe peripheral causal conditions that are supplementary to each other. For instance, a configuration typology would include a few stable conditions that are densely connected to and reinforced by peripheral conditions that can be mutually interchangeable. Neutral permutations can be used for the “exploration of viable strategic alternatives, particularly with a focus on understanding intratype similarities and dissimilarities” (Fiss, 2011: 398; Reger & Huff, 1993). Distinct typologies defined primarily by their core attributes are deemed to be of first order equifinality while interchangeable peripheral conditions refer to second order equifinality. In the present study, the identification of core and peripheral conditions was based on an analysis of commonalities between configurations in the solution.

The notation for results suggested by Ragin and Fiss (2008) takes the form of a table with the causal conditions in the lines and the resulting configurations in the columns. The cells contain black dots to indicate the presence of the corresponding causal condition in a configuration, while a crossed circle signals its absence. Also, large black dots and crossed circles indicate core conditions while small ones are peripheral (Fiss, 2011). It should be noted that absence in this context means that the absence of the corresponding characteristic is required in the configuration. Empty cells mean that the absence or presence of the corresponding condition has no impact in a configuration. In the interpretation, empty cells are interesting to understand the robustness of certain configurations in the face of change. For instance, if the condition munificence has no impact, a particular configuration can be expected to remain conducive to the outcome even if market growth slows down.

5 RESULTS

5.1 Sample of Private Firms

The first part of the analysis uses the fsQCA software to analyze the configurations that lead to above average performance in a sample of 942 private firms. The intermediate solution used here relies on theoretically-driven assumptions about some conditions. Assumptions were only included in the cases that were strongly supported by the literature: executive incentives, shareholders' rights and large minority investors are expected to be "present" in configurations leading to performance. The truth table constructed by the software contains 512 theoretically possible combinations of conditions. To determine which combinations would be part of the model, the thresholds that maximized the product of overall coverage and overall consistency in the solution were a minimum frequency of 4 and a consistency threshold of 0.93. The minimum frequency of 4 leaves 69% of cases in the analysis, which is slightly below the ideal of 80% suggested in the literature but still keeps a reasonable number of cases given the size of the sample. Table 14 presents the configurations that resulted from the analysis. The final solution contains nine causal paths to performance and covers 49.6% of the outcome subset. The overall consistency of the solution of 90.4% is very high. This means that there are indeed dominant models of successful private firms in the Chinese landscape. The nine causal paths were grouped in the table according to their commonalities. This produces four categories of configurations to which labels were attributed based on interpretation. Many configurations come in two distinct versions (marked a and b) that differ according to the peripheral conditions. These versions result in second-order equifinality involving functional equivalents. For example, this can be observed in the neutral permutations between *supervisory board* (1a) and *board independence* (1b) in the Market pressure model or between *management incentives* (3a) and *proactive disclosure* (3b) in the Insider-control model. Each configuration is discussed in detail below.

Table 14. Configurations leading to performance in private firms

Causal conditions	Market pressure		Outsiders' voice		Insider-control			Politically embedded	
	1a	1b	2a	2b	3a	3b	4	5a	5b
Board independence	∅	•	●	●				•	
Enabling SH meetings			●	●			∅	●	●
Proactive disclosure	●	●	●	●		•	∅	●	●
Management incentives	●	●	•		•		●	●	●
Large minority shareholders	●	●		•	●	●	●	●	●
Large controlling shareholder			●	●	●	●	∅		•
Supervisory board	•	∅	•		∅	∅	●		∅
Political leadership	∅	∅	∅	∅	∅	∅	∅	●	●
Political connections	∅	∅	∅	∅	∅	∅	∅	●	●
Raw coverage	0,23	0,2	0,1	0,14	0,23	0,22	0,19	0,04	0,02
Unique coverage	0,04	0,01	0,01	0,01	0,04	0,03	0,03	0,02	0
Consistency	0,93	0,93	0,93	0,92	0,93	0,93	0,92	0,94	0,94
Overall coverage: 0.496					Overall consistency: 0.904				
●= core (present), ∅= core (absent), •= peripheral (present), ∅= peripheral (absent)									

Table 15 exhibits a number of descriptive statistics specific to the four configurations and the whole sample. They include the number of firms covered, geographic location, industry groupings and selected statistics. For the location, provinces are grouped in regions as follow: East (Anhui, Fujian, Jiangsu, Jiangxi, Shandong, Shanghai and Zhejiang), North (Beijing, Hebei, Inner Mongolia, Shanxi and Tianjin), Northeast (Heilongjiang, Jilin and Liaoning), Northwest (Gansu, Ningxia, Qinghai, Shaanxi and Xinjiang), South Central (Guangdong, Guangxi, Hainan, Henan, Hubei and Hunan) and Southwest (Chongqing, Guizhou, Sichuan, Tibet and Yunnan). Industries are aggregated into three categories: low value production (agriculture, food, textile, paper and metals), high value manufacturing (petrochemical transformation, electronics, machinery, pharmaceuticals and other manufacturing) and services (construction, IT, retail, real estate, social services, media and conglomerates). The other descriptive statistics included in the table are the average firm size (total assets), average firm age, average size of the board of directors, average number

of meetings of the board per year and the proportion of firms that display CEO duality (board chairman and CEO is the same person). Other statistics were gathered and are used selectively in the detailed description of configurations below.

Table 15. Descriptive statistics: Configurations in sample of private firms

	Sample	<u>Configurations</u>			
		Market pressure	Outsiders' voice	Insider-control	Politically embedded
Number of firms	942	97	34	76	23
<u>Location</u>					
East	44,6%	47,4%	47,1%	55,3%	60,9%
North	10,5%	8,2%	8,8%	10,5%	8,7%
Northeast	4,0%	3,1%	5,9%	1,3%	4,3%
Northwest	3,5%	0,0%	0,0%	0,0%	0,0%
Southcentral	30,1%	37,1%	38,2%	31,6%	21,7%
Southwest	7,2%	4,1%	0,0%	1,3%	4,3%
<u>Industry</u>					
Low value	21,3%	13,4%	29,4%	21,1%	34,8%
high value	49,3%	61,9%	41,2%	59,2%	52,2%
Services	29,4%	24,7%	29,4%	19,7%	13,0%
<u>Other average stats</u>					
Size (assets, mn RMB)	2728	2239	3100	2230	2913
Firm age (years)	10,08	6,11	6,32	5,04	6,96
Board size (members)	8,55	8,43	7,82	8,37	8,61
Board meetings (yearly)	8,94	9,09	10,74	7,89	9,96
CEO duality	33,7%	43,3%	32,4%	43,4%	34,8%

Configuration 1: market pressure. This configuration covers 97 firms, with paths 1a and 1b covering respectively 59 and 38 firms. Like nearly all causal paths in the table, this configuration excludes any form of political connections. Apart from the absence of political leadership and political connections generally, the core conditions of this configuration consist of the presence of large minority shareholders, the presence of proactive disclosure and the presence of management incentives. These three conditions

together resonate with the typical corporate governance bundle found in outsider control systems that discipline the firm through market pressure, providing informed shareholders with an effective exit option and aligning the interests of managers with those of any other small investors. Specifically, the presence of large minority investors complemented by proactive disclosure ensures effective pressure from market forces, much like the discipline instilled by a healthy market for corporate control. Also, the fact that this configuration leads to performance regardless of the proportion of shares of the largest shareholder suggests that a high level of management shareholding is an effective mechanism to reduce potential principal-agent problems. The core conditions are complemented by peripheral and mutually exclusive elements involving either an independent board (1b) or an active supervisory board (1a). The presence of these peripheral conditions suggests that this configuration needs a minimal level of internal oversight. Following insights from the literature on the outsider control system, the predicted compatible condition would be the presence of independent directors to increase the level of board vigilance. Yet, there is a possible neutral permutation between board independence and an active supervisory board, suggesting that these two conditions can act as functional equivalents. A possible interpretation for this finding is that the professionalization of corporate governance in recent years has enabled the supervisory board under certain circumstances to perform the monitoring role typically expected from an independent board of directors. However, the fact that these two conditions are mutually exclusive suggests that, in the context of the *market pressure model*, this monitoring role must be carried out by either of the two boards but not both.

The reliance on market forces is coherent with the fact that firms with this configuration are disproportionately present in the two industries with the highest stock turnover ratio (electronics and other manufacturing) while they are nearly absent from the two industries with the lowest stock turnover ratio (retail and food production). Similarly, it is not surprising that this configuration has the highest average shareholding by investment funds (15.6% compared to an average of 13.2% in the rest of the solution set), which are known for short term orientation. Generally, firms in configuration 1 are found predominantly in high value manufacturing industries and are scarcely present in low value production. In the services, it is interesting to note that configuration 1b covers 40% of firms in IT services in the solution set (10 out of 25). In terms of location, there is a slight overrepresentation in the

South Central region. Configuration 1a covers 4 out of 6 firms in the Southwest in the solution set. Overall, configuration 1 is the closest to the outsider control ideal type model with features of proactive disclosure, management incentives and a relatively dispersed ownership structure that provides a disciplining effect from market forces.

Configuration 2: outsiders' voice. Paths 2a and 2b respectively cover 22 and 27 firms. Like the previous one, this configuration is also devoid of political connections. Its core features include the dominance of the largest shareholder and the presence of participation mechanisms available to external investors within the governance structure. Minority shareholders have enabling instruments at their disposal to participate during annual meetings, have access to timely information and are represented by a critical mass of independent directors on the board. This suggests that the large controlling shareholder faces enough scrutiny to forego potential excesses of appropriation of private benefits of control. While ownership concentration in the hands of the largest shareholder is associated with an insider-control system, the three elements described above (shareholder meeting, disclosure and board independence) are typical of an outsider-control system, which results in a hybrid form of internal discipline by a dominant owner and external discipline through outsiders' voice. Apart from these core conditions, there is a neutral permutation, this time not mutually exclusive, between large minority shareholders in path 2b and management incentives with an active supervisory board in path 2a. It is worth pointing out that every single causal path in the solution exhibits either management incentives or the combination of a large controlling shareholder, large minority shareholders and proactive disclosure. This suggests that containing agency costs requires either highly concentrated ownership among the top 10 shareholders with informed minority holders or significant management shareholding. This explains the observed permutation between management incentives and large minority shareholders in configuration 2.

Further supporting the reliance on *voice* mechanism is the fact that the operations of the board of directors in this configuration increase the level of board vigilance. Configuration 2 has the highest average number of board meetings and the smallest average board size, which has been found to contribute to effective monitoring (Cheng, Evans, & Nagarajan, 2008; Jensen, 1993; Jia et al., 2009; Yermack, 1996). This is especially salient in

configuration 2a, which has the smallest board of directors on average (7.4 members) holding the most meetings (11.4). Similarly, it shows the lowest rate of CEO duality, which further supports the level of board vigilance. Also, firms in this configuration present the highest average foreign shareholding in the form of strategic investments (5.2% compared to 3.1% in the rest of the solution set). In the Chinese context, the foreign parties involved in such investments typically adopt a long term orientation and are usually more used to participating in a firm's governance than domestic ones. In terms of location, firms in configuration 2 are disproportionately present in South Central China, especially in the province of Guangdong where 40% of firms covered by configuration 2b are based. Configuration 2 is overrepresented in the low value production industries and 37% of firms covered by path 2b are in services. To sum up, configuration 2 presents a hybrid form between the outsider-control system with its concentrated ownership and the outsider-control systems with effective participation mechanisms for shareholders, including an enabling shareholder meeting, proactive disclosure and an independent board.

Configurations 3 and 4: insider-control. Three paths are covered in this category grouped in two separate configurations: 3a, 3b and 4, respectively covering 56, 41 and 9 firms. As with the previous ones, the configurations in this category require the absence of political connections. The first configuration (3a & 3b) involves highly concentrated ownership (large minority shareholders and large controlling shareholder) and an inactive supervisory board. Path 3a presents an insiders' alliance between large minority shareholders, a dominant controlling owner and managers owning stocks. In path 3b, in the absence of management incentive like in configuration 2, proactive disclosure represents a functional equivalent enabling large minority shareholders to be effective watchdogs. Configuration 4 also falls under the heading of insider-control configurations, with the difference that it exhibits more ownership dispersion because of the absence of a dominant shareholder. This suggests an alliance of multiple large minority shareholders that are probably directly involved in management. In this sense, management incentives are effective to contain principal-agent problems. This seems to loosely follow the model of a family business with scarce disclosure, closed governance, and the presence of an active two tier board to solve the collective action problems among multiple stakeholders with long term interests.

Successful insider-control configurations appear predominantly in Eastern provinces, especially in Jiangsu and Zhejiang where 40% of firms in configuration 3 are located. The firms covered are disproportionately present in the high value manufacturing industries. Path 3a covers nearly half of the firms in petrochemical manufacturing in the solution set (15 out of 33). Still, it also covers half of the firms in agriculture (3 out of 6). On average, firms in this path are by far the youngest (4.5 years). 5 out of 9 firms covered by configuration 4 are in IT services. Overall, configurations 3 and 4 are the closest forms among private enterprises to the insider-control ideal type system with a concentrated ownership and very few OECD-prescribed corporate governance practices.

Configuration 5: Politically embedded. This configuration offers the only model involving political connections in the solution set for private firms. Paths 5a and 5b respectively cover 17 and 10 firms. The first striking feature is that despite the fact that at least twice more firms have political connections than political leadership, political leadership is necessary in the only two paths involving political embeddedness in the solution set for private firms. Also, nearly all best practices from the outsider-control system must be present for this model of politically connected private firms to achieve performance, including proactive disclosure, management incentives and enabling shareholders meetings. The combination of multiple elements of the outsider-control system with political connections akin to the multiplex relationships typically found in insider-control systems represents a creative hybrid form that balances the OECD-like best practices of corporate governance with features of political governance inherited from the Chinese past. Apart from these core conditions, path 5b includes a large controlling owner. As discussed in the literature review, a large controlling shareholder can be necessary to contain undue political influence. Interestingly, there is a neutral permutation between a large controlling shareholder and board independence (path 5a). This offers the possibility that a critical mass of independent directors may act as a functional equivalent to a large controlling shareholder regarding the task of maintaining adverse political pressures in check.

Although 60% of firms covered by configuration 5 are in Eastern provinces, none is based in Shanghai. 30% of paths 5a and 5b are located in Zhejiang province. While this configuration is disproportionately present in low value production, 65% of firms covered

by path 5a operate in high value manufacturing industries. Overall, configuration 5 represents a hybrid form between political governance and the outsider-control ideal type system, featuring both political connections and corporate governance best practices such as proactive disclosure, management incentives and enabling shareholder meetings.

5.2 Sample of State-Owned Enterprises (SOEs)

The second section of the empirical analysis concerns the sample of 810 state-owned enterprises. As in the previous section, set theoretic analysis operationalized through fsQCA is used to identify configurations that lead to above average firm performance. To produce the intermediate solution reported below, theoretically driven assumptions were set in the model. For purposes of comparability, the same assumptions used in the first section were kept in the model for SOEs: executive incentives and large minority shareholders were both marked as *present*. The third assumption in the first section concerned shareholders meeting procedures. As explained earlier, this is the only condition that is not included in the present section. It is replaced by the condition *SASAC*, which signals that the firm is ultimately controlled by the central SASAC. Based on the extent literature, this condition was also marked as *present*. The six remaining conditions were left as *present or absent*. To select the combinations to be used in the analysis out of the 512 theoretically possible combinations appearing in the truth table, the minimum frequency and the consistency threshold were selected through a process of iteration aimed at maximizing the overall coverage and overall consistency of the solution. The resulting frequency cut-off of 3 left 74% of all cases in the model. A consistency threshold of .9 was used.

Table 16 below presents the resulting solution set containing five configurations grouped into three categories. Three configurations contain two separate versions for a total of eight causal paths. The overall consistency of 90.4% is coincidentally exactly equal to that of the sample of private firms. However, the overall coverage of the solution is much lower at 29.5%. This remains within an acceptable range. With a comparable sample, Fiss (2011) reported solutions with overall coverages of 27% and 36%. Still, this lower coverage indicates that there is more dispersion among successful SOEs in a multitude of

configurations. The causal paths identified here are the dominant ones, but this does not disqualify other potential combinations leading to performance. Still, while the causal paths presented in the previous section covered a number of firms ranging from 9 to 59, the coverage here ranges from 3 to 20 firms. While analyzing these configurations provide valid insights about the bundles of practices used by successful firms, the reader should keep in mind that these causal paths are observed in a more limited number of cases.

Table 16. Configurations leading to performance in SOEs

Causal conditions	External pressure			Insider-control			National champions	
	1	2a	2b	3a	3b	4	5a	5b
Board independence	∅	∅	•	∅	∅	∅	∅	•
Proactive disclosure	●		∅	●	●	●	∅	•
Management incentives	●	•				•		
Large minority shareholders	●	●	●	•	•		●	●
Large controlling shareholder	∅	∅	∅	●	●	●	●	●
Supervisory board		•	•	∅	•	∅	∅	•
Political leadership	∅	∅	∅	∅	∅	∅	∅	•
Political connections		•	•	∅	•	•	●	●
SASAC	∅			∅	∅		●	●
Raw coverage	0,108	0,084	0,1	0,135	0,117	0,082	0,044	0,021
Unique coverage	0,018	0,004	0,011	0,013	0,002	0,023	0,014	0,021
Consistency	0,914	0,902	0,905	0,907	0,914	0,909	0,893	0,927
Overall coverage: 0.295 Overall consistency: 0.904								
●= core (present), ∅= core (absent), •= peripheral (present), ∅= peripheral (absent)								

Table 17 provides descriptive statistics specific to the three groups of configurations and the comparison with the sample of SOEs. The statistics reported here are the same as in the previous section, including the number of firms covered, the geographic location, the aggregate industrial sector, and selected other data points (firm size, firm age, BOD size, number of BOD meetings and CEO duality). It is worth noting that the sample of SOEs is more evenly distributed across all Chinese regions than the sample of private firms, which was more concentrated in the Eastern and South Central regions. The industrial sector is also

slightly less concentrated in the high value manufacturing. Finally, SOEs generally exhibit a much larger average size (10 806 million RMB compared to 2 728). SOEs are also older, with an average age of 13.7 years compared to 10.1 years in the private sector. The difference is much larger when considering the average age of firms that appear in the solution sets of profitable firms: 11.7 years for SOEs VS 5.9 years for private firms.

Table 17. Descriptive statistics: Configurations in sample of SOEs

	Sample	Configurations		
		External pressure	Insider-control	National champions
Number of firms	810	28	18	6
<u>Location</u>				
East	36,8%	46,4%	44,4%	33,3%
North	17,5%	10,7%	16,7%	16,7%
Northeast	7,2%	3,6%	5,6%	16,7%
Northwest	8,0%	0,0%	0,0%	0,0%
Southcentral	21,6%	28,6%	16,7%	16,7%
Southwest	8,9%	10,7%	16,7%	16,7%
<u>Industry</u>				
Low value	24,2%	17,9%	11,1%	0,0%
high value	42,5%	50,0%	50,0%	83,3%
Services	33,3%	32,1%	38,9%	16,7%
<u>Other average stats</u>				
Size (assets, mn RMB)	10806	5826	6761	11929
Firm age (years)	13,68	12,64	10,44	11,33
Board size (members)	9,30	9,75	9,33	10,67
Board meetings	8,72	9,46	8,50	7,67
CEO duality	9,5%	14,3%	16,7%	0,0%

Configurations 1 and 2: external pressure. This category covers three causal paths present in two configurations: 1, 2a and 2b, which respectively cover 20, 11 and 4 firms. These configurations are primarily characterized by the fact that the largest shareholder holds a relatively small proportion of shares and by the presence of large minority

shareholders. In other words, the state agency controlling the firm is not overly dominant in terms of shareholding compared to other investors. Yet, configurations 1 and 2 differ on the mechanisms used to discipline the firm to achieve performance. Although both are subject to a form of external pressure, configuration 1 relies on market forces while configuration 2 relies on political steering. Configuration 1 is very similar to the first configuration observed in the solution set of private firms, involving market pressure. Indeed, large minority shareholders enjoy timely information disclosure that enable more efficient monitoring. This is coupled with management incentives to align the interests of decision makers with those of external investors. The fact that configuration 1 does not involve political connections while relying on market pressure makes it the closest to the outsider-control model. Configuration 2, on the other hand, does not rely on disclosure but rather on political connections and an active supervisory board. As predicted by theory, a supervisory board can play an important role to balance the interests of powerful stakeholders such as politically connected agents. As already observed in configuration 5 in the solution set for private firms, configuration 2 provides evidence that political connections are not necessarily complementary with a large controlling shareholder. However, like in most paths in the solution set, configurations 1 and 2 exclude a politically connected leadership.

In the absence of a large controlling shareholder, management incentives in paths 1 and 2a help mitigating principal-agent problems. Path 2b is the only one across both solution sets of private firms and SOEs that does not involve either management incentives or very concentrated ownership. It is worth reiterating the fact that the presence of politically involved individuals can discipline managers and pressure them to conform to guidelines. Also, as observed in politically embedded private firms earlier, the presence of an independent board in this diverging path (2b) may play an important role to curtail undue political influence in the absence of a large controlling shareholder. While firms covered by path 2a do not involve board independence, they hold the highest average number of board meetings (10.5 compared to 8.5 in the rest of the solution set). *External pressure* configurations are disproportionately present in Eastern China and in the South Central region, which resembles the location of successful private firms. Overall, configuration 1 is the closest among SOEs to the outsider-control ideal type system with a dispersed ownership structure and best corporate governance practices including proactive disclosure and

management incentives. Configuration 2 conforms to the heritage of political governance, with political connections and an active supervisory board. Its dispersed ownership structure shows that politically embedded forms of governance do not necessarily require ownership concentration.

Configurations 3 and 4: insider-control. Insider-control configurations concern paths 3a, 3b and 4, which respectively cover 6, 5 and 7 firms. The defining feature of configurations 3 and 4 is that they rely on a large proportion of shares held by the controlling owner. The use of proactive disclosure as a core condition suggests a need for a form of external oversight. This however does not translate into effective participation by outsiders like in the *outsiders' voice* model for private firms since they all rely on an insider-dominated board of directors. Configurations 3 and 4 differ in the previously identified mechanisms used to curtail principal-agent problems. Indeed, paths 3a and 3b rely on very concentrated ownership involving the additional presence of large minority shareholders, while path 4 uses management incentives. The combination of management incentives and political connections in configuration 4, which was also observed in path 2a, falsifies the theoretical prediction that these two elements are incompatible. Finally, the two causal paths observed in configuration 3 display a neutral permutation involving wither the presence of two conditions together, or their absence: political connections and an active board of supervisors. Specifically, while both of these conditions are present in path 3b, they are both absent in path 3a. This mirrors the complementarities already observed between these two elements in configuration 2, supporting the idea that the supervisory board can play a role to coordinate the interests of diverse stakeholders.

On average, firms covered by insider-control configurations are quite evenly distributed across geographic regions, with a slight overrepresentation in Eastern provinces. They are underrepresented in low value production industries. Four out of five firms covered by path 3b operate in high value manufacturing industries. Also, five out of seven firms covered by configuration 4 are in services. Surprisingly, firms in configuration 3 that involve political connections (3b) are much younger on average (8.5 years VS 14.5 years) than firms without political connections (3a). This shows that features of political governance inherited from the past are not necessarily concentrated in older firms. To sum up, configurations 3 and 4

are the closest forms to the insider-control ideal type system with very concentrated ownership and few best practices of corporate governance, with the exception of proactive disclosure.

Configuration 5: national champions. Configuration 5 concerns paths 5a and 5b, which both only cover 3 firms. The defining feature of this configuration is that it applies to firms ultimately controlled by the central asset management agency, the SASAC. They display strong features from the insider-control system, including political connections and very concentrated ownership by both the controlling owner and large minority shareholders. However, paths 5a and 5b rely on peripheral conditions that offer wildly different combinations of conditions that both involve some form of hybridization.

Path 5b involves the presence of features from both the insider- and the outsider-control systems. On the one hand, they rely on board independence and proactive disclosure, which strengthens the formal mechanisms of external oversight. On the other hand, they rely on an active supervisory board and are the only firms in the solution set that have a politically connected leadership. It should be noted that the only other path in the solution set of SEOs that involves board independence (2b) also relies on an active supervisory board and political connections. Apart from these two, every other path in the solution displays insider-dominated boards. This suggests that independent directors in state-owned firms might not play a typical role of monitoring in the name of small investors. Path 5a exhibits the exact opposite peripheral conditions of path 5b, relying on the absence of both external oversight (board independence and proactive disclosure) and the insider-control elements (political leadership and an active supervisory board). While these firms did let go the heritage of political governance, they do not buy into OECD-inspired best practices of corporate governance.

On top of relying on an insider-dominated board, path 5a displays the highest average board size (11 directors VS 9.6 in the rest of the solution set) and the fewest board meetings (6 VS 9.1), which is predicted to reduce board vigilance. Also, firms in path 5a are much older than firms in 5b (15 VS 7 years). The six firms in the *national champions* configuration present by far the largest average size across both sections of the empirical analysis. They are not geographically concentrated but nearly all operated in high value manufacturing industries.

All three firms covered by path 5a are in petrochemical manufacturing. Overall, configuration 5 leans more towards the insider-control ideal type system relying on concentrated ownership, with features of political governance. Where the corporate leadership is also politically connected, firms adopt more practices that usually belong to outsider-control systems, presenting a creative hybrid between the three models discussed in the literature.

5.3 Additional General Findings

Apart from the detailed presentation of each configuration, a number of important general findings deserve additional discussion. Primarily, the results of the configuration analysis clearly show a healthy level of heterogeneity of forms of corporate governance in the Chinese domestic market. Both private firms and SOEs use models that lean towards both insider-control systems and insider-control systems. Several instances of hybridization involving elements of both archetypes in creative governance forms are observed. A surprising finding concerns the fact that there are more configurations in the SOEs sample than in the private firms sample involving the absence of a very large controlling owner. It was predicted that ownership dispersion was complementary with western best practices of corporate governance. It appears that there is a larger diversity of governance forms in state firms that rely to some extent on ownership dispersion. Counter to the expectation that ownership dispersion is to be found in outsider-control systems, two of those three configurations involve political connections and an active supervisory board. This unexpected hybrid form testifies for the fertile ground for experimentation in the Chinese organizational landscape. Two other examples of hybrids are found in the sample of private firms. The *outsiders' voice* configuration involves the presence of participation mechanisms for external investors such as an independent board, proactive disclosure and an enabling shareholder meeting in firms that have a large controlling shareholder. Also, politically embedded private firms display nearly every best practice of corporate governance prescribed by the OECD.

Secondly, many configurations rely on functional equivalents, which are observed through neutral permutations of peripheral conditions across causal paths. The results show that principal-agent problems can be mitigated by either highly concentrated ownership or by management incentives. Also, undue political pressure can be mitigated by either ownership concentration or, in the absence of a dominant controlling owner, by an independent board. While different conditions can play a similar role, a condition can have different functions in different contexts. It appears that the supervisory board, when it is effectively active, plays a different role in private firms and SOEs. While many politically embedded configurations in SOEs rely on supervisory boards as a broker of interests among stakeholders, the boards are absent or insignificant in the two politically connected configurations of private firms.

Thirdly, political connections are still playing an important role in the Chinese corporate elite. In particular, 5 of the 8 causal paths identified for the SOEs sample involved political connections. In fact, for SOEs, there is at least one politically embedded version of each model in the solution. Also, the only two politically embedded configurations in the first sample involve political leadership, whereas SOEs use multiple models in which political connections are core conditions while political leadership is absent. This demonstrates that the dominant models of successful SOEs must hire unaffiliated leadership to reliably achieve performance. On the other hand, political leadership in private firms seems to benefit from centrality in the decision making power, possibly to exert more control on the other politically involved individuals among the top personnel.

Fourthly, the overall effects of three conditions deserve additional attention. Large minority shareholders are present and are often a core condition in nearly all the causal paths. In both solution sets, the presence of large minority shareholders appears to be a quasi-necessary condition. Their role is obviously different across distinct configurations, sometimes embodying the threat of the market for corporate control, sometimes monitoring controlling owners from the outside, and sometimes being an active part in insider-control models. Also, disclosure is a present condition in a majority of models in both samples, with very few configurations relying on the absence of proactive disclosure. Finally, management incentives are generally much more effective in private firms than in SOEs. Even in the models involving political leadership, management shareholding seems to play a critical

role. In SOEs, the only configuration including political leadership evidently also involves political appointment, which ties the overall compensation to political agencies.

Fifthly, one further remark worth mentioning concerns some specific effects of political embeddedness on private firms. It has been argued that politically connected firms might enjoy preferential access to capital in the form of bank loans. Some further analysis was conducted to test this assertion. The fact that the firms covered by the politically embedded configuration in the sample of private firms present the highest leverage ratio of liabilities to total assets (.42 compared with .27 in the rest of the solution set) seems to support this prediction. Also, the fact that this configuration contains the only two paths that involve political embeddedness in the sample of private firms and covers only 11% of firms within the solution set raises the question whether this inherited but persistent feature can be expected to vanish in the future. While a longitudinal analysis falls outside the boundaries of the present study, two measures of growth potential were used to assess whether the success of these firms is likely to carry on. Dittmar, Mahrt-Smith and Servaes (2003) use the market to book ratio as a proxy for investment opportunities. The other proxy, inspired from Fan et al. (2007), uses the future sales growth as another proxy (sales at $t+1$ / sales). Firms covered by configuration 5 display the highest market to book ratio (2.81 compared to 2.67 in the rest of the solution set) and the highest future sales growth (1.41 compared with 1.26 for the others). This suggests that politically embedded private firms can not only exhibit above average performance, but present thriving business prospects.

6 CONCLUSION

This paper has sought to bridge the literatures on comparative corporate governance and on political embeddedness to study the heterogeneity of forms of corporate governance at the firm level that lead to economic performance in a transition economy. The elements of corporate governance incorporated in the model are derived from two archetypes of control systems (Franks & Mayer, 1997; Garcia-Castro et al., 2013; Jenkinson & Mayer, 1992): the insider-control system, which relies on ownership concentration and a two-tier board to coordinate the interests of powerful stakeholders, and the outsider-control system, which

defines the Anglo-American model involving typical Western best-practices including board independence, incentive compensation, a market for corporate control and ownership dispersion. The use of such models at the firm level is warranted by Whitley's (2006) work showing that heterogeneity can be observed within a domestic market and the tradition of research on hybrid forms in transition economies (Boisot & Child, 1996; Nee, 1992). These creative forms may involve different practices that act as functional equivalents (Ahlering & Deakin, 2007), including China-specific features of political embeddedness inherited from the socialist past (Wong et al., 2004).

China indeed offers a well suited institutional environment to study the relation between political embeddedness and corporate governance. Many reforms have been implemented to professionalize corporate governance since the turn of the millennium, pegging the formal legislation to Western best practices. These efforts were particularly aimed at reforming state-owned enterprises and support the development of the private sector (Qian & Wu, 2003). Yet, the regime tolerates a gap between *de jure* regulation and *de facto* practices, allowing a decoupling between commitment to reforms and actual implementation and enforcement (Opper & Schwaag-Serger, 2008). In this context, the institutions of political governance show resilience and maintain influence through Party committees, political affiliation of top executives within the Party Nomenklatura and enduring state ownership in many listed firms (Allen & Shen, 2012; Brødsgaard, 2012).

To explore the heterogeneity of corporate governance forms that lead to performance in China, the empirical study takes a configurational perspective operationalized through fuzzy-set qualitative comparative analysis (Fiss, 2007; Ragin, 2000, 2008a). The analysis is conducted separately on a sample of 942 private firms and a sample of 810 SOEs. This set theoretic method lets emerge in an exploratory fashion the complex causal relationships between the many combinations of corporate governance practices and firm performance. The model allows to identify the complementarities among the nine conditions included in the models: board independence, management incentives, proactive disclosure, large minority investors, the proportion of shares of the largest shareholder, an active supervisory board, political leadership, political ties, a participation-enabling shareholders meeting (only in private sample) and whether the firm is controlled by the SASAC (only in SOE sample).

The solution set for private firms results in nine causal paths grouped into four distinct categories of corporate governance forms. Firstly, the *market pressure* configuration concerns firms with multiple large minority shareholders without any dominant one. Management incentives instill discipline to prevent principal-agent conflicts and proactive disclosure provides timely information to investors for monitoring purposes. Secondly, the *outsiders' voice* configuration involves a large controlling owner, but provides effective mechanisms to external investors to participate in the firm's governance, including proactive disclosure, an enabling shareholders meeting and an independent board. Thirdly, the *insider-control* configurations involve concentrated ownership and the absence of Western best practices of corporate governance. Fourthly, the *politically embedded* configuration presents an interesting hybrid form whereby firms have strong political ties, including a politically connected leadership, but also rely on best corporate governance practices.

The solution set for SOEs results in eight causal paths grouped into three categories of corporate governance forms. Firstly, the *external pressure* configuration is characterized by the relatively low proportion of shares held by the controlling state agency. In the first version of this form, discipline is instilled through market pressure by informed large minority investors and by management incentives. In the second version, a supervisory board helps coordinating various stakeholders, including large minority shareholders and political agents. Secondly, the *insider-control* configurations relies on ownership concentration and a form of external oversight provided by proactive disclosure. Thirdly, the *national champions* configuration applies to firms ultimately controlled by the central asset management commission, the SASAC. These firms are politically connected and rely on very concentrated ownership with both a large proportion of shares by the controlling owner and the presence of large minority investors. Two distinct versions of this configuration are observed. One displays an interesting hybrid form involving the presence of political leadership and an active supervisory board, but also an independent board of directors and proactive disclosure. The other relies on the absence of these four peripheral conditions.

Apart from documenting in detail successful configurations of corporate governance in China, these results provide a number of interesting findings. A high variety of corporate

governance forms that lead to profitability coexist under the current Chinese regulatory regime. In both samples of private firms and SOEs, there are configurations that lean closer to each ideal type control system. Most firms implement corporate governance structures that do not align perfectly with any model, but selectively adopt practices from each ideal-type system to create successful hybrid forms. This supports the idea that distinct practices can act as functional equivalents to either discipline management, reduce appropriation of private benefits by insiders or generally achieve performance. Moreover, proactive disclosure and large minority investors both play a positive role in most configurations across the two samples. Generally, management incentives play a more important role in private firms. Also, the coordination function of an active supervisory board as broker of interests between political agents and other stakeholders is more salient in SOEs.

These findings offer important contributions to the literature¹³. Firstly, the analysis helps to reconcile the equivocal findings from the literature on political embeddedness and firm performance (Faccio, 2006; Fan et al., 2007), outlining the specific bundles of practices in which political connections contribute to performance in both SOEs and private firms. By the same token, these insights contribute to the debate between hypotheses of the helping hand the grabbing hand of the state (Frye & Shleifer, 1997; Shleifer & Vishny, 1998). In essence, the main proposition of this chapter is that whether the hand of the state, either in the form of direct equity control or through informal political networks, brings net benefits to firms depends on complementarities with other features of the ownership or governance structures. Still, while many governance configurations in SOEs can lead to performance, the more limited coverage of the main models of profitable SOEs compared to that of private firms suggests that the state sector is still experimenting.

Secondly, the substantial heterogeneity and the presence of hybrid forms of corporate governance supports the idea that laws and regulations around stock-listed firms do not pre-determine business-to-government relations, nor do they steer towards an ideal-type model suggested in the literature: insider control system for SOEs, as opposed to outsider control system for the private sector. The multitude of governance forms of profitable firms is a

¹³ See the general conclusion for an in depth discussion of the contributions.

clear indication that the regulatory framework leaves choices, facilitating the search for contextually suited bundles of corporate governance practices by recombining elements pertaining to distinct models. The fact that no ideal-type model tends to become dominant challenges the convergence hypothesis (Hansmann & Kraakman, 2001) and suggests that there remains substantial heterogeneity not only at the international level (Khanna et al., 2006), but also at the domestic level.

Thirdly, the institutions of political governance inherited from the past in China are adapting to the new reality. The Chinese regulatory regime accommodates the coexistence of a large variety of successful forms, including those relying on enduring political networks. This suggests that the recombined forms of governance may not be symptomatic of a so-called transition phase, but rather prove to be persistent in time. Features of political governance are adapting and political embeddedness is felt beyond the typical Party Committees (Allen & Shen, 2012; Nee et al., 2007; Wong et al., 2004) into new decision making bodies such as the board of directors and the board of supervisors. Yet, while political embeddedness prevails in a majority of configurations that apply to SOEs, a striking finding rests in the fact that the three dominant categories of causal paths in the sample of private firms are devoid of political connections.

An important limitation to this study stems directly from the choice of methodology. Focusing on configurations does not provide insight on individual practices in firms beyond those covered by the dominant causal paths. This limitation is more salient in the SOEs sample given the smaller coverage. Another limitation of the empirical study is the lack of longitudinal perspective. One can only speculate that if many politically embedded forms of corporate governance survive in 2010, it is likely that many of their complementary features will survive beyond the so-called state of reform. Despite the identification of hybrid forms, the research design lacks the perspective to qualify in better detail the dynamics at play in the co-evolutionary processes of legal reform towards international standards and the consolidation of politically embedded national champions.

Another limitation comes from the choices of measures used in the operationalization. The most important construct in this study is firm performance, which is used as the outcome variable. For reasons explained earlier, an accounting measure was preferred to stock return

data because of the Chinese context where the stock pricing mechanism is not efficient enough to provide informative signals (Chen et al., 2011; Peng, 2004). Still, firm performance is one of the most common construct used in the management literature and it carries inherent limitations (Venkatraman & Ramanujam, 1986). March and Sutton's (1997) dissection of the construct is the most notable review of the difficulties inherent to measuring the overall performance of an organization. They explain that a performance advantage is competitively unstable and that the typical operationalization of performance analysis "tends to eliminate variation in both the determinants and their effects" through imitation of best practices (March & Sutton, 1997: 699). While the present study is not fully exempt from it, this limitation is more acute in the case of statistical methods. A configuration analysis has more power to account for the variation in determinants across cases by inherently incorporating equifinality. Another problem identified by March and Sutton (1997) lies in the time frame employed in the analysis. The short term effects of a determinant may differ from its long term effects. For instance, in the present chapter this problem applies to the relation between an active supervisory board and performance. While an active board may increase performance, it is possible that a board will increase its activity following a period of weak performance in order to achieve better results in the next period (Vafeas, 1999). Another time-related limitation identified by Richard, Devinney, Yip and Johnson (2009) is that accounting performance focuses on past performance and may provide little indication of future performance. They call for longitudinal studies, as well as using various alternative methods and using various measures of performance to reduce error, improve construct validity and generally better align the research context with the measure of organizational performance. Indeed, combining various measures of performance may allow to better capture the broader concept of organizational effectiveness since financial performance alone is not a relevant measure for all stakeholders, but mainly for shareholders (Lin Fitzgerald & James E. Storbeck, 2003). Similarly, because of data limitation, the measurement of the concept of proactive disclosure included in this study was based on only two components. While some studies have used single measures (see for instance Li, Pike, & Haniffa, 2008 on intellectual capital disclosure), many use indices that include many elements of voluntary disclosure (García-Meca & Sánchez-Ballesta, 2010). Such indices are not available for China. Finally, while the two distinct measures of political embeddedness

used in this study (active political participation by top individuals and by firm leadership) encompass a much broader net of political ties than most studies, it is important to remember that they still represent only one facet of the interface between businesses and the Party.

To conclude, this chapter provides insights that open interesting paths for future research. A fruitful area would be to explore in detail the corporate governance configurations that were dominant early in the reform process. It would be very insightful to conduct in depth case studies on firms in each configurations identified here to confirm and enrich the analysis about the causal mechanisms. It would also be relevant to conduct a similar analysis on other transition economies to validate the generalizability of the findings. The insights from this chapter also raise important considerations for other streams of literature. Firstly, the importance of the political networks documented here warrants the explicit inclusion of political attributes in analyses of social networks in corporations in transition economies such as the board interlocks studied through formal network analysis (Ren, Au, & Birtch, 2008). Secondly, the role of informal political connections and their interactions with the ownership structure should be taken into account in studies analyzing business group formation (Carney, Gedajlovic, Heugens, Essen, & Oosterhout, 2011), especially in transition economies. Finally, the findings are relevant for research in international economic diplomacy concerning the treatment of foreign SOEs in antitrust cases and more generally regarding infringement of competition policy (Backer, 2010; Sappington & Sidak, 2003; Zimmerman, 2010). While the identification of foreign state-owned enterprises is based on ownership by the government, the findings suggests that the state in transition economies may enjoy decision making rights that stem from informal networks of political ties.

CHAPTER 4 – GENERAL CONCLUSION

1 THE DISSERTATION’S AIM AND MOTIVATION

The corporate governance regime in emerging countries diverges from ideal-type systems. In particular, transition economies are difficult to frame in normative models since their institutional framework is inherently evolving during the process of reforms from a command economy to a market economy. China is the textbook example of a transition economy that embodies the institutional tensions between an inherited system of political governance and a new legal framework transplanted from Western countries and empowering external shareholders on capital markets. On the one hand, the legal reforms adopted and implemented in China have largely followed the guidelines predicted by the convergence hypothesis of corporate governance emphasizing the primacy of shareholders, while accommodating for some features pertaining to a more stakeholder-oriented model such as the establishment of boards of supervisors. On the other hand, the decoupling from legislation to practice and the strong participation of the state both in terms of ownership and political connections contribute to the resilience of informal institutions of political governance.

China is therefore a fantastic case of institutional tensions in corporate governance between new legal reforms versus inherited political institutions, between professionalization and standardization versus informal channels of influence. Confronted with these evolving institutional tensions, firms face a great challenge in designing a corporate governance structure that can align the interests of stakeholders, maintain internal coherence with the ownership structure and external consistency with the institutional environment, and mitigate the most salient governance problems. In this context, can effective and dominant forms of corporate governance emerge? If so, what forms and whose interests do they serve?

This doctoral dissertation was designed to answer these questions and contribute to understanding how firms in transition economies navigate often conflicting institutional

tensions. The analysis offers a more nuanced view of corporate governance problems in transition economies, focusing on China as a business system characterized by ill-defined property rights and underdeveloped capital markets. At first sight these two conditions seem to suggest that models of corporate governance, such as the outsider or insider control models might render only poor explanatory values as both rely on clearly defined ownership rights and functioning capital markets. Yet, the analysis shows novel ideas about how Chinese firms found solutions by which the corporate governance structures within and around firms can help to cope with changes in the external environment, in particular the resilience of political influence on firms' strategic behavior. Despite ill-defined property rights and underdeveloped capital markets, firms must conceive structures that efficiently allocate decision making rights and income rights to mitigate conflicts of interests between owners and managers, insiders and outsiders, shareholders and other stakeholders (Aguilera & Jackson, 2003; Daily et al., 2003; Shleifer & Vishny, 1997). These corporate governance mechanisms must be compatible with the firm's ownership structure and take into account the contingencies set by the institutional environment (Aguilera et al., 2008).

The conceptual frameworks were based on existing models found in the literature but incorporate elements of political governance and state control to really dive into the complexity of the Chinese corporate governance landscape. Adapting the ideal type models was necessary because they were built for the Western context and because they assume that systems are national, with a substantial level of domestic homogeneity across firms. It was therefore crucial to adopt a research design that would allow dropping the premise of homogeneity to account for a larger spectrum of forms of corporate governance that emerges out of the spontaneous process of recombination observed in China. For this purpose, the configurational approach through set theoretic methods is especially useful to study complementarities, functional equivalents and equifinality (Fiss, 2007). Accordingly, the two empirical studies in this doctoral thesis adopted a configurational perspective on corporate governance in the context of a transition economy, using the fsQCA software to study large samples of Chinese listed firms during the last decade (Ragin, 2008a). The results point to important complementarities among practices and to bundles of causal conditions that have not received enough scholarly attention.

2 SUMMARY OF THE RESULTS

The second chapter of the thesis (*Principal-principal relationships at the core of corporate governance problems in China: A set theoretic analysis*) looks at the specific corporate governance problem that is the most salient in Chinese listed firms: the diversion of cash flow from the firm by the controlling shareholder. This problem arises from a misalignment of interests among principals when the controlling shareholder enjoys sufficient control rights in the context of very concentrated ownership to appropriate a disproportionate share of the firm's cash flow (Claessens et al., 2002). Such diversion of assets is known as tunneling (Friedman et al., 2003). Most often in China this takes the form of inter-firm loans, whereby the firm transfers money to another corporate entity (Jiang et al., 2010). Typically, the controlling shareholder controls both entities, but enjoys higher income rights in the firm on the receiving end of the transfer. These related party transactions have received considerable attention in scholarly work as they represent the biggest corporate governance problem in Asia generally and in China specifically (OECD, 2009a). Still, most of the empirical literature that has attempted to identify the determinants of tunneling has produced mixed and equivocal results. The task of isolating the effect of variables with statistical models has proved elusive.

The empirical study designed for this dissertation uses a configurational approach to analyze the interactions among key causal conditions, allowing for asymmetry and substitution effects. The results are particularly useful to identify under which conditions a given variable is involved in the causal path leading to the outcome. The findings distinguish three conditions that set in place the incentives and the mechanisms that allow tunneling: a relatively small proportion of shares (cash flow rights) held by the largest shareholder, a high financial leverage (indebtedness) and a small firm size. The presence of any two of these three conditions is sufficient to set the tunneling incentives and mechanisms. This interaction is symmetric because the opposites of these conditions are observed in firms that do not engage in tunneling behavior. Specifically, the presence of any two out of three of these opposite conditions is sufficient to avoid tunneling: a relatively large proportion of shares held by the largest shareholder, a low financial leverage and a large firm size.

In addition, the results show that a lack of monitoring plays an enabling role towards tunneling. Provided that tunneling incentives and mechanisms are in place, the absence of any two out of these three corporate governance practices is sufficient to enable tunneling: proactive disclosure, independent internal audit and board independence. This finding is not symmetric because the presence or absence of monitoring does not matter in the absence of tunneling incentives and mechanisms. Also, implementing good governance practices cannot deter tunneling if incentives are in place. Finally, board independence has an adverse effect in firms with large minority shareholders and in those controlled by a state agency. These results suggest that board independence can be used as a rent generating mechanism and that independent directors play an instrumental role for collusion among various insiders to facilitate tunneling behavior.

The third chapter of the thesis (*Political Embeddedness and Corporate Governance: Heterogeneity and Hybridization in China*) looks beyond specific governance problems and adopts a broader approach to analyze the heterogeneity of the Chinese corporate governance landscape. This exploratory empirical study dives into the core question of how firms respond to the institutional tensions arising from the amalgamation of features of political governance inherited from the socialist past with the recent wave of legal reforms aimed at professionalizing corporate governance practices according to international standards (Allen & Shen, 2012; Opper & Schwaag-Serger, 2008). Specifically, it compares a sample of private firms and a sample of SOEs to identify the corporate governance forms that are implemented by profitable firms in these two distinct institutional contexts. The elements of corporate governance used in the model are derived from three competing systems reviewed in the literature: the outsider control system mainly observed in Anglo-Saxon countries, the insider-control system mainly observed in continental Europe and Japan, and the politically embedded system of administrative governance observed in command economies. The results exhibit a high level of heterogeneity of successful corporate governance forms. None of the dominant forms identified in the solution conforms integrally to the ideal-type systems identified in the literature. Although some are close relatives of these archetypes, most are creative hybrid forms.

The solution for the sample of private firms exhibits four main corporate governance forms. *Market pressure* configurations rely on proactive disclosure, executive incentives and the presence of large minority investors that bring a disciplining effect akin to that of a healthy market for corporate control. *Outsiders' voice* configurations appear in firms with highly concentrated ownership that implement multiple monitoring mechanisms: proactive disclosure, board independence and participation-enhancing procedures during the shareholders' meetings. These two forms are the closest relatives of the outsider control system, although they do not depend on dispersed ownership. *Insider-control* configurations come in two breeds. The first involves a large controlling shareholder and also large minority investors, thus producing a very concentrated ownership structure. The second is an alliance of insiders that bears a resemblance with the governance structure of family firms, coordinated by an active supervisory board and comprising multiple large shareholders and managers that own relatively large parts of the stock. As its label suggests, this form is the closest to the insider-control system. *Politically embedded* configurations are interesting hybrids that rely on large minority investors and on political connections, including in the top leadership (CEO or board chairman), while implementing most of the corporate governance practices prescribed in international standards: executive incentives, proactive disclosure and shareholder meetings that enable participation by small investors.

The solution for the sample of SOEs shows three dominant corporate governance forms. There are two versions of *External pressure* configurations that all exhibit a relatively small shareholding by the controlling owner. The first resembles the market pressure configuration for private firms and relies on proactive disclosure, executive incentives and large minority shareholders to discipline the firm through market forces. The second relies on a supervisory board to coordinate the influence of powerful stakeholders, including political agents and large minority investors. *Insider-control* configurations rely on a large controlling shareholder, proactive disclosure and a mix of peripheral conditions that may include political connections, a supervisory board or executive incentives. *National champions* configurations concern firms that are ultimately controlled by the SASAC of the State Council and rely on a very concentrated ownership structure and political connections.

3 THEORETICAL IMPLICATIONS

The findings of the two empirical studies challenge some dominant ideas in the literature and have implications that raise questions for future research. The most important conclusion is that, even in transition economies, *property rights matter* for allocating decision making rights between large and minority shareholders and can also be found at the base of ‘alliances’ between shareholders and stakeholders. The second most important conclusion is that *political connections matter*, but not as much as is commonly assumed. Thus for example a great number of private firms operate profitably without any political connection. Moreover, political ties are not enough. Since many firms are politically embedded, normal political connections do not provide a competitive advantage, but political ties among the corporate leaders can provide an additional edge in order to (re-)allocate decision making rights. In state firms, a *clearer distinction between income rights and control rights* shows that some state agencies are satisfied with an appropriate return to their investment, prioritizing their income rights and exercising restraint with their control rights. In other firms, the state appears to have a preference for strong control rights, allowing them to appropriate cash flow for purposes that diverge from profit maximization. The extent of those *principal-principal problems* depends on the checks and balances set forth in the governance structure and alliances among shareholders and stakeholders. *Principal-agent problems*, regardless of whether they concern a state or private firm, are most frequently solved by offering incentive contracts to top executives, in the form of share ownership by managers, or by tight internal controls in the case of firms with very concentrated ownership among the largest shareholders. In what follows, a more detailed discussion presents the theoretical contributions that concerns the literature on corporate governance, on political connections in business and on transition economies.

Literature on corporate governance. This dissertation provides four important contributions to the literature on corporate governance. Firstly, it offers a thick analysis of principal-principal problems in the context of weak property rights and ill-functioning market institutions. The existing empirical literature on this problem, based mostly on statistical methods, has so far failed to produce conclusive results about the determinants of expropriation by the controlling shareholder (Chen et al., 2009; Huyghebaert & Wang, 2012;

Jiang et al., 2010; Wang & Xiao, 2011). The configurational analysis reported here allows disaggregating the problem into two main components: the drivers and the monitoring. Three main drivers set the incentives and mechanisms for tunneling behavior in the form of related-party loans, which is the dominant form of cash flow expropriation in China and more generally in Asia. If these drivers are absent, monitoring mechanisms are mostly superfluous. If these drivers are present, a lack of monitoring enables tunneling, but the implementation of monitoring mechanisms through corporate governance practices cannot reliably prevent tunneling. While the three drivers are stable across configurations, the features involved in monitoring may vary depending on the ownership structure.

Secondly, this thesis provides fresh support for the idea that corporate governance practices should be studied as bundles of interdependent elements (Aguilera et al., 2008; Garcia-Castro et al., 2013; Misangyi & Acharya, 2014; Rediker & Seth, 1995). The results of both empirical studies include complements, substitutes and asymmetric effects. Studying the various elements involved in corporate governance structures in isolation obscures the complexity of their causal relationship with outcome variables. While set theoretic methods have quickly gained ground in the literature, the two studies are additional examples that such methods offer a valuable alternative to statistical methods to study causal complexity even in large-N samples. Previous studies on principal-agent problems have documented the possibility for causal conditions within a corporate governance bundle to be simultaneously complements and substitutes (i.e. “any two of these three conditions is sufficient for...”) (Garcia-Castro et al., 2013; Misangyi & Acharya, 2014). This dissertation confirms that this type of interaction can also apply to the analysis of principal-principal problems.

Thirdly, while the variety of corporate governance models across countries has been documented exhaustively by the comparative corporate governance literature (Aguilera & Jackson, 2010), this thesis reports substantial diversity at the national level. While it is possible to categorize national regulatory frameworks in broad families and while it is useful to theorize ideal-type systems, the observed domestic landscape of corporate governance forms is wildly heterogeneous. This suggests that country labels for corporate governance models represent a gross over-simplification. By the same token, the debate on the global convergence of corporate governance obscures the fact that while firms may adopt structures

that are closer or farther from a given ideal-type model (Hansmann & Kraakman, 2012), most create forms that fit the contingencies provided by their institutional environment and that provide complementarities with their ownership structure and life cycle.

Fourthly, this dissertation brings additional evidence to the growing body of empirical work that adopts a critical view on the role and impact of independent directors (Chen et al., 2011; Huyghebaert & Wang, 2012; Peng, 2004; Su et al., 2008). Independent directors can play a crucial role to monitor managers since they are assumed not to be in conflict of interests. Critics have argued that in practice, they may lack information on the firm's operations and culture, and they may have little time and resources to invest in the monitoring activities expected from them. The results in chapter 3 of this thesis provide a mixed picture about their impact. For private firms, less than half of the configurations leading to performance relied on an independent board. The results in SOEs are striking: six successful configurations rely on the *absence* of board independence while only two rely on its presence. The findings in chapter 2 even show that independent directors are instrumental to collusion that facilitates tunneling in firms with large minority shareholders and in SOEs. These results clearly indicate that not only may independent directors be ill-equipped to properly monitor insiders, but that they actually often collaborate with them to the detriment of external shareholders. More in-depth intra-board case studies seem necessary to understand how independent directors could be empowered and incentivized to fulfil their duty.

Literature on political connections in business. This dissertation also contributes to two important aspects of the literature on political connections in business: the shape of those political ties and how they interplay with other channels of business to government relations, and their effect on economic performance at the firm level. Firstly, the dissertation contributes to the literature on political ties by disentangling the many shapes of state and political influence in businesses, clarifying the distinct roles of regulatory reform, state ownership and informal political ties. There is already a large body of literature on the first two elements. Given its administrative monopoly, the state has an inherent but indirect influence through legislation and regulation. Many scholars have studied whether and how new legal requirements, such as those on the professionalization of corporate governance,

can trigger effective changes in the formal structures of listed firms (Berkowitz et al., 2003; Edelman & Suchman, 2007; Pistor et al., 2000) . The most direct influence of the state is channeled through state ownership. In the Chinese case, state agencies at various levels remain in control of a large share of the economy. By concentrating state assets in selected sectors with strategic importance, the government influences the degree of competition on the market for all firms (Du & Wang, 2013; Li, Liu, & Wang, 2014). While these two channels of influence have been documented in detail by a large body of literature, Chapter 3 provides an empirical account of a much more subtle and opaque channel of influence that has received little scholarly attention (Brødsgaard, 2012): the tight networks between the corporate elite and the political elite. In the Chinese case, the literature on political connections has either focused on the Party Committees (Allen & Shen, 2012; Nee et al., 2007; Wong et al., 2004) or on politically tied CEOs (Fan et al., 2007). This dissertation extends this literature by showing that political connections go far beyond these accounts and by offering a novel measure to assess these networks. Indeed, the results indicate that political agents can assume key positions in many decision making bodies, including various positions on the board of directors, board of supervisors and other top executive positions. In chapter 3, political agents are defined and measured as those individuals that, in addition to their corporate position, actively participate in the political apparatus by concurrently holding outside the firm a formal position for the Party. This provides an informal but very effective channel of communication between the corporate elite and the political elite and questions the primary allegiance of business leaders. These informal influence channels, coupled with the fact that weak enforcement can be a signal that the state is willing to let firms implement new legal tools selectively, suggest that laws do not pre-determine business to government relations. *De facto* relations endure much beyond the *de jure* prescriptions of standardization of governance.

Secondly, while research on the influence of state ownership and of informal political connections on firm performance is often studied in parallel streams of literature, this dissertation offers an integrated account based on the configurational perspective. Part of the debate on the effect of state influence on economic performance has been synthesized in the literature through the metaphor of the helping hand versus the grabbing hand of the state (Cheung et al., 2010; Frye & Shleifer, 1997; Shleifer & Vishny, 1998). State actors can help

mitigate regulatory uncertainty and provide access to valuable resources such as capital, information or other resources. Yet, they are often rent seeking and pursue objectives that diverge from the interests of shareholders such as maximizing employment or state revenues. The debate on the resulting firm level effect is largely unresolved since empirical studies often offer contradicting findings. The same problems apply to the literature on political connections in which scholars have sought to analyze the impact of politically connected CEOs on the performance of listed firms (Faccio, 2006; Fan et al., 2007). This thesis helps reconciling some of the past equivocal results using a configuration perspective that allows to identify the conditions on which the effectiveness or ineffectiveness of state-ownership and political connections are contingent. The evidence reported in chapter 3 suggests that both state-ownership and informal political ties can play a crucial role for firms to achieve performance, but not under any conditions. The study identifies particular combinations of practices that can complement state or political influence in configurations that are conducive to performance. For instance, supervisory boards can help brokering between the influence of political agents and that of other stakeholders. Overall, most profitable private firms are not politically embedded. In the minority that are, political ties appear at the top leadership level. Among successful SOEs, many corporate governance forms rely on informal political connections in addition to state equity ownership, but nearly all have corporate leaders that are not politically embedded. Chapter 2 also clarifies the corporate governance configurations in which state ownership is detrimental to external shareholders and those where it is not.

Literature on transition economies. Finally, this dissertation contributes to the literature on transition economies (Boisot & Child, 1996; Grabher & Stark, 1997a; Krug & Hendrichske, 2012; Nee & Opper, 2012; Peng & Luo, 2000; Pistor et al., 2000; Pistor & Xu, 2005). Post-socialist markets are often portrayed on a simplistic linear dimension in which institutions are slowly evolving from central control towards market driven mechanisms. They are in between, in a transitory phase and have not yet fully matured. What is less clear is the elusive destination, the final state expected in these normative accounts. The exploratory empirical studies reported in this thesis reveal a much more complex and interesting picture. The picture is interesting because transition economies are indeed implementing sweeping reforms to their legal infrastructure creating a very dynamic

institutional environment. The picture is complex because economic actors in transition economies are subject to institutional tensions that follow from a clash between inherited but persistent features of political governance and new legal frameworks that effectively empower shareholders on the capital market. The fact that transition is not a simple linear process, but rather a dynamic one that results from complex institutional tensions, has three main implications: (1) markets in transition are shaped from bottom-up by firm responses, (2) the fact that the regime accommodates this heterogeneity challenges the convergence hypothesis, and (3) the explicit integration of political networks is necessary in any serious attempt to understand the reality of corporate governance in transition economies.

Firstly, firms respond to institutional tensions in different ways. The Chinese market harbors firms that are still rooted in the system of political governance, but where old features have evolved to allow political agents to invest the new governance structures enabled by the reforms. It also harbors firms that have parted with this past and adopt corporate governance structures that fully rely on market forces, implementing effective monitoring mechanisms empowering outsiders. The former may still rely predominantly on capital channeled through large state owned banks, while the latter target the equity market and slowly evolve into more dispersed ownership structures. And in between, most firms actually implement creative hybrid forms tailored according to their specific context. These results strongly support Nee and Opper's (2012) proposition that market transition is largely steered from bottom up by the economic actors themselves as opposed to the idea of a trajectory being imposed from top-down by the state.

Secondly, the findings show a very diverse pool of firms that manage to achieve performance through distinct governance models. It appears that the Chinese regime accommodates a very heterogeneous field of corporate governance, where distinct institutional features cohabit to allow firms to experiment with various solutions. The observed reality does not suggest that some forms are vanishing altogether while others are succeeding, but rather that all forms are simultaneously adapting to the changing environment. This heterogeneity of successful corporate governance forms supports the view that the present state may not be a transitory phase after all, or at least not in the normative sense typically advanced. The fact that old features of political governance remain useful to many firms suggest a resilience

and adaptability that challenges the convergence hypothesis (Hansmann & Kraakman, 2001; Sachs & Woo, 2001).

Thirdly, the contributions discussed above about corporate governance and political connections are relevant to the literature on transition economies since the evidence reported concerns a post-socialist market. The new forms of informal political influence channels are particularly important. China, as many transition economies, is still governed by a single party. The influence of the Party Nomenklatura stretches in many economic spheres where the state sector has effectively been withdrawing over time. In other words, while firms have responded creatively to the changing institutional environment, the state has also responded creatively to the changing business environment. Yet, such political networks in the Chinese corporate world have received little attention in research. This dissertation testifies for the importance of studying the breadth and the effects of these networks. The Chinese market has scarcely been studied through formal network analysis (Ren et al., 2008). Network analysis of top officers and politically connected directors and executives would provide invaluable information on many issues pertaining to corporate governance in transition economies, including investor-investee relationships, business-group formation and governance, information dissemination and the role of coordinating bodies such as the SASAC.

4 PRACTICAL IMPLICATIONS

This dissertation also has practical implications for managers, investors and policy makers. The heterogeneity of successful corporate governance forms suggests that one size does not fit all. In this sense, policy makers would be advised to put forward a regulatory framework that adopts a comply-or-explain approach rather than a rigid enforcement of prescribed norms to better allow firms to experiment with creative solutions to flexible problems. However, in the context of weak legal enforcement, the failure of the corporate governance practices put forward by the Chinese legislation and expected to prevent tunneling by means of privately enforced monitoring mechanisms set by contractual relationships has many shortcomings. The fact that these governance practices are ineffective to prevent cash flow

diversion when the interests of principals are not aligned suggests that policy makers have to go back to the corporate governance drawing board. Still, this dissertation points to some contractual arrangements in terms of firm governance that should be preferred by small investors. In particular, proactive disclosure is beneficial to investors in most of the reported solutions. Minority shareholders should forcefully advocate for better and timelier disclosure in listed firms. Similarly, minority investors should welcome compensation packages that increase management shareholding in private firms. This dissertation shows that management shareholding in private firms can contribute to mitigate principal-agent problems and, under certain conditions, help limiting the expropriation of cash flow by insiders. This cannot be said of independent boards. Small shareholders should be very cautious with their expectations regarding the duty of independent directors to act as watchdogs for their interests and demand accountability. The results indeed suggest that independent directors may collaborate with insiders to expropriation cash flow, especially in SOEs.

Also, this dissertation is relevant to policy makers abroad in their negotiations of economic agreements with China. China is often still presented as an emerging market. It has long been defined by international observers according to its trade and investment flows. Now, China has emerged. It has an enviable position in the geographically fragmented production chains across East Asia and its domestic market is growing exponentially. The focus of trade negotiations with China has already evolved from border measures to behind-the-border measures pertaining to domestic national and local regulations that can hamper business activities by foreigners. An in depth understanding of the Chinese market structure is paramount to identify the potential constraints to cross-border trade and investment relations. The role of the state is often cited in international economic diplomacy as a very opaque but crucial element. Foreign governments are increasingly concerned with anti-trust issues regarding state firms from China and seemingly private firms that may receive covert support from the state. The findings reported in this dissertation contribute with a detailed account of the shape and impact of business to government relations in large Chinese corporations. More specifically, the results warrant a nuanced analysis involving factors that go beyond formal ownership rights to account for informal political influence when differentiating private firms from state owned enterprises. Such clear cut categories cannot

account for the subtle varieties of politically connected firms in China. As Chinese firms are increasingly active on the international market for mergers and acquisitions, such knowledge is also relevant to managers in target firms abroad to understand the effective decision making structure and incentives of Chinese acquirers.

5 CONCLUDING REMARKS

The ambition of this dissertation was to document the observed heterogeneity of corporate governance forms in the context of imperfect market institutions. China represented a timely object of study since the recent wave of radical corporate governance reforms have created institutional tensions with the institutions of political governance and have produced various responses by economic actors. China is also an important object of study since it has become and will remain a prominent player in the world economy. The corporate governance problems experienced by Chinese firms are not unique to China. Yet, some of the solutions are certainly tainted by its particular history and context. It is the author's hope that the findings will inspire further set theoretic research on corporate governance in China, in other transition economies and in other countries where firms face institutional tensions.

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SUMMARY (ENGLISH)

Corporate governance in transition economies does not fit in the dominant normative models. China embodies institutional tensions between an inherited system of political governance and new laws transplanted from Western countries that empower external shareholders on capital markets. Despite ill-defined property rights and underdeveloped capital markets, firms must conceive governance structures that mitigate conflicts of interests and that maintain internal coherence with their ownership structure and external consistency with the institutional environment.

This dissertation takes a configuration perspective to offer a nuanced view that accounts for the full spectrum of forms of corporate governance that emerged out of the process of recombination observed in China. The two empirical studies apply set theoretic methods on large samples of Chinese listed firms to uncover the causal complexity involved in corporate governance problems, focusing on the complementarities, functional equivalence and causal asymmetry observed among elements of corporate governance. The first study analyses the configurations that facilitate and deter the most salient governance problem: the diversion of cash flow from the firm by controlling shareholders through tunneling. The second study analyses the diversity of governance forms in successful firms, including politically embedded firms, those that rely on outsider control systems resembling the Anglo-American model, as well as creative hybrid forms.

The dissertation shows that, even in transition economies, property rights matter for allocating decision making rights between large and minority shareholders. Also, political connections matter, but not as much as is commonly assumed since many private firms operate profitably without any political ties. In addition, the observed domestic heterogeneity of forms compels (1) to move beyond traditional national-level classifications of governance models and (2) to drop the conception of “transition” as a linear process towards market institutions in favor of a finer understanding that accommodates a diversified landscape including resilient features of political governance. Finally, the thesis commands caution regarding the role of independent directors, who not only fail to provide effective monitoring on insiders, but often facilitate collusion easing tunneling behavior.

SUMMARY (DUTCH)

Corporate Governance in een Veranderende Markt: Heterogene Reacties op Institutionele Spanningen in China

Corporate governance in overgangseconomieën komt niet overeen met de heersende normatieve modellen. China belichaamt institutionele spanningen tussen een overerfd politiek governance systeem en nieuwe wetten, overgenomen van Westerse landen, die macht geven aan externe aandeelhouders op de kapitaalmarkt. In weerwil van slecht gedefinieerde eigendomsrechten en onderontwikkelde kapitaalmarkten moeten bedrijven governancestructuren bedenken die belangenverstrengeling beperken, interne coherentie met de eigendomsstructuur waarborgen en consistent zijn aan de externe institutionele omgeving.

Dit proefschrift neemt een configurationeel perspectief om een genuanceerd beeld te bieden van het volledige spectrum aan vormen van corporate governance die voortgekomen zijn uit het spontane proces van recombinitie, waarneembaar in China. De twee empirische studies passen “set theoretische” methode (d.w.z. “Qualitative Comparative Analysis”) toe op grote steekproeven van Chinese beursgenoteerde bedrijven om de causale complexiteit van problemen rondom corporate governance bloot te leggen, met aandacht voor de complementariteit, functionele gelijkwaardigheid en causale asymmetrie die zichtbaar is tussen de verschillende onderdelen van corporate governance. De eerste studie analyseert de configuraties die het meest in het oog springende governanceprobleem faciliteren en verhinderen: het wegschuiven van geldstromen van de organisatie door aandeelhouders te controleren, een proces dat “tunneling” heet. De tweede studie analyseert de diversiteit van governancevormen in succesvolle organisaties, waaronder bedrijven die verankerd zijn in de politiek, bedrijven die afhankelijk zijn van externe controlesystemen overeenkomstig met het Anglo-Amerikaanse model, alsook creatieve hybride vormen.

Het proefschrift toont aan dat zelfs in overgangseconomieën eigendomsrecht van belang is voor het toewijzen van besluitvormingsrechten tussen grote- en minderheidsaandeelhouders. Ook maken politieke banden verschil, maar niet zoveel als vaak wordt aangenomen aangezien veel private bedrijven winstgevend zijn zonder politieke betrekkingen te hebben. Daarnaast dwingt de waargenomen binnenlandse heterogeniteit in governancestructuren om (1) traditionele nationale classificaties van governancemodellen te overstijgen en (2) de opvatting van “transitie” als lineair proces richting marktinstituties te vervangen met een geraffineerder begrip waarin plaats is voor een gediversificeerd landschap inclusief de veerkrachtige eigenschappen van politieke governance. Tot slot stuurt het proefschrift aan op waakzaamheid met betrekking tot de rol van onafhankelijke bestuurders, die niet alleen tekortschieten in het bieden van effectief toezicht op insiders, maar vaak ook samenspanning faciliteren en tunneling vergemakkelijken.

SUMMARY (FRENCH)

Gouvernance d'entreprise lors de la transition à l'économie de marché : Réponses hétérogènes aux tensions institutionnelles en Chine

La gouvernance d'entreprise dans les économies en transition diverge des modèles dominants. La Chine présente des tensions institutionnelles entre un héritage de gouvernance politique et une vague récente de réformes calquées sur les normes occidentales s'appuyant sur la primauté des actionnaires. Malgré un marché des capitaux peu développé et des droits de propriété mal définis, les entreprises doivent concevoir des pratiques de gouvernance cohérentes avec leur structure actionnariale, harmonieuses avec l'environnement institutionnel et permettant de limiter les conflits d'intérêts.

Cette thèse adopte une perspective configurationnelle pour offrir une vision nuancée tenant compte de l'éventail complet des formes de gouvernance d'entreprise ayant émergées du processus d'hybridation observé en Chine. Les deux études empiriques appliquent, sur de larges échantillons d'entreprises chinoises, une méthode issue de la théorie des ensembles (fsQCA) pour documenter la complexité causale propre aux problèmes de gouvernance et mettant l'accent sur les effets complémentaires, substitutifs et asymétriques observés parmi les éléments de gouvernance. La première étude analyse les configurations qui facilitent et limitent le principal problème de gouvernance: le détournement de capitaux par les actionnaires de contrôle. La deuxième étude analyse la diversité des formes de gouvernance dans les entreprises performantes, incluant les entreprises bénéficiant de connexions politiques, celles s'appuyant sur les systèmes de contrôle externe similaires au modèle anglo-américain, ainsi que certaines ayant des formes hybrides innovantes.

La thèse démontre que, même dans les économies en transition, les droits de propriété ont un effet déterminant sur l'attribution du pouvoir décisionnel entre les actionnaires majoritaires et minoritaires. De même, les connexions politiques importent, mais façon modérée puisque plusieurs entreprises privées performant sans réseau politique. En outre, la diversité observée des formes de gouvernance dicte (1) un développement théorique dépassant les classifications nationales traditionnelles de modèles de gouvernance et (2) l'évolution du concept de «transition» compris comme un processus linéaire de réforme à finalité libérale vers une compréhension plus fine d'un portrait diversifié comprenant des éléments résilients de gouvernance politique. Enfin, les résultats constituent une mise en garde concernant le rôle des administrateurs indépendants, qui non seulement échouent à assurer un contrôle efficace des dirigeants, mais facilitent souvent la collusion menant au détournement de capitaux.

SUMMARY (MANDARIN)

市场转型过程中的公司治理—对中国制度性矛盾的多样化反应

主流的公司治理规范模型并不适用于转型中的经济体。在中国，制度性矛盾体现在由历史演变而来的政治治理体系与从西方国家引进的授权于金融市场的股东的法律之间的对立。面对不明确的产权制度和发达的金融市场，公司还必须找到能够缓解利益冲突，对内能与公司所有权匹配，对外能和制度环境保持一致的治理结构。

本文从配置的角度提出了一个新颖的观点，解释了中国发现的自发性重组过程中涌现出的所有公司治理的形式。这两个基于大量中国上市公司样本的实证研究揭示了公司治理中的因果复杂性问题，聚焦于互补性、功能对等以及因果不对称等这些在公司治理中出现的因素。第一个研究分析了有利于解决公司治理中最突出问题的配置，例如控股股东通过利益输送来实现公司资金流的转移的问题。第二个研究分析了那些成功的公司的多样化的治理模式，包括政策嵌入型公司，以及那些依赖于外部控制系统的类似于英美模式的公司，以及一些创造型的混合治理模式。

论文指出，即使在转型中的经济体，财产权关系到在大股东和散户股东之间如何分配决定权利。同时，政治关联也有影响，尽管这种影响不像通常认为的那么显著因为许多私人企业在毫无政治关联的情况下也能经营并盈利。另外，那些观察到的国内多样化的治理形式迫使超越传统管制模型国家等级分类，将“转型”的概念作为转向市场经济的线性过程，支持一种更好的理解来适用于包括政府管制弹性特征在内的多种所有制经济。最后，本文提出必须关注独立董事的职责，因为许多独立董事不仅不能对内部交易进行有效的内部监管，还经常促使共谋，使得利益输送行为变得容易。

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Pierre Olivier L. Tremblay was born in 1982 in Montréal. He obtained an undergraduate degree in finance from HEC Montréal. During his degree, he completed two terms at ESADE in Barcelona and a summer program in leadership with the Iacocca Institute at Lehigh University. His academic and extracurricular achievement earned him several distinctions, including the Lieutenant Governor Award, the Mercure excellence profile and excellence scholarships from Fondation Bouthillier-Dubord, Promo 96 Fund, Sun Chemicals Inc. and a National Excellence Scholarship of the Canadian Millennium Foundation.

Pierre-Olivier earned an Msc. in international political economy at the London School of Economics (LSE) where his dissertation analyzed Vietnam's accession to the WTO. He then worked for the European Centre for International Political Economy (ECIPE), a Brussels based think tank, producing research and policy briefs on Sino-European trade relations. He also worked as inter-scholar in the Assemblée Nationale du Québec, under a scholarship from the Fondation Jean-Charles-Bonenfant, producing research on provincial-level participation in international trade negotiations. Finally, he was hired by the Research Centre on International Studies (CÉRIUM) of the University of Montréal to produce studies on Quebec-India relations for the Government of Québec.

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CORPORATE GOVERNANCE DURING MARKET TRANSITION HETEROGENEOUS RESPONSES TO INSTITUTIONAL TENSIONS IN CHINA

Corporate governance in transition economies does not fit in the dominant normative models. China embodies institutional tensions between an inherited system of political governance and new laws transplanted from Western countries that empower external shareholders on capital markets.

The two empirical studies in this dissertation apply set theoretic methods on large samples of Chinese listed firms to uncover the causal complexity involved in corporate governance problems, focusing on the complementarities, functional equivalence and causal asymmetry. The first study analyses the configurations that facilitate and deter the most salient governance problem: the diversion of cash flow from the firm by controlling shareholders through tunneling. The second study analyses the diversity of governance forms in successful firms, including politically embedded firms, those that rely on outsider control systems resembling the Anglo-American model, as well as creative hybrid forms.

The dissertation shows that, even in transition economies, property rights matter for allocating decision making rights between large and minority shareholders. Also, political connections matter, but not as much as is commonly assumed since many private firms operate profitably without any political ties. In addition, the observed domestic heterogeneity of forms compels to drop the conception of "transition" as a linear process towards market institutions in favor of a finer understanding that accommodates a diversified landscape including resilient features of political governance. Finally, the thesis commands caution regarding the role of independent directors, who not only fail to provide effective monitoring on insiders, but often facilitate collusion easing tunneling behavior.

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