

Are OECD-prescribed “good corporate governance practices” really good in an emerging economy?

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Abstract This paper examines whether adopting OECD-prescribed corporate governance principles can solve the major corporate governance problem in an emerging economy—controlling-shareholder expropriation. We argue that “good governance practices” in OECD countries (e.g., an active board of directors, separation of chairperson and the CEO, significant presence of outside directors, and a two-tier board) cannot mitigate the negative effect of controlling-shareholder expropriation on corporate performance for two main reasons. First, most good governance practices are mainly designed to resolve conflicts between shareholders and the management but not conflicts between controlling and minority shareholders. Second, board directors are typically not independent to controlling shareholders, and supervisory directors often have low status and weak power in a firm. Using a panel of over 1,100 Chinese listed firms between 2001 and 2003, we find supportive evidence for our arguments. We discuss the implication of our study for public policy and strategies of investors.

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In emerging economies, the major concern of corporate governance in publicly listed companies is *controlling-shareholder expropriation*, whereby controlling shareholders pursue their self-interests at the expense of corporate performance and the interests of minority shareholders (Claessens & Fan, 2002; Su, Xu, & Phan, 2007; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). Controlling-shareholder expropriation can take different forms: appointing unqualified friends or family members as senior managers, engaging in self-beneficial trades, advancing personal, familial, and political agendas that hamper corporate performance, and “expropriating” the profits of lower-tier companies in a pyramid business group (Claessens, Djankov, & Lang, 2000). Controlling-shareholder expropriation has been described in the corporate governance literature as tunneling (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000), expropriation against minority owner (Faccio, Lang, & Young, 2001), entrenchment (Claessens, Djankov, Fan, & Lang, 2002), private benefits of control (Denis & McConnell, 2003), or more recently principal-principal conflicts (Jiang & Peng, 2010; Su et al., 2007; Young et al., 2008).

This study investigates factors that can mitigate controlling-shareholder expropriation in an emerging economy. In particular, we focus on the role of “good practices” of corporate governance prescribed by the Organization for Economic Cooperation and Development (OECD, 1999, 2004). The good corporate governance practices include an active board of directors, separation of chairperson and chief executive officer (CEO), outside directors as a majority of the board, and a two-tier board (using a board of supervisors to monitor a board of directors) (OECD, 1999, 2004). These internal corporate governance mechanisms may be particularly important for limiting misappropriation of controlling shareholders and protecting the interests of minority shareholders in emerging economies because the underdeveloped legal institutions and financial markets in the countries make external mechanisms (e.g., legal enforcement of property rights, creditor monitoring, and hostile takeovers) less effective in disciplining the behavior of controlling shareholders (La Porta, Lopez-de-Silanes, & Shleifer, 1999; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000). Indeed, governments in many emerging economies have endorsed this view and requested or recommended that their companies adopt some or all of the existing corporate governance practices in OECD countries to enhance corporate governance in those economies (Feinerman, 2007; Jesover & Kirkpatrick, 2005).

Notwithstanding, there is little empirical evidence that recommended OECD corporate governance practices effectively counterbalance the power of controlling shareholders and thus reduce the adverse consequences of controlling-shareholder expropriation on corporate performance. To our knowledge, our study represents one of the first to tackle this important question—whether OECD “good practices” of corporate governance are good in an emerging economy—both theoretically and empirically. Specifically, we first analyze the causes of controlling-shareholder expropriation and their negative impact on firm performance. We recognize that controlling shareholders can be state or privately owned, and we argue that, in both

types of organizations, expropriation costs are salient, albeit for different reasons. We further posit that in an emerging economy, neither the board of directors, nor the board of supervisors are effective in counterbalancing expropriation activities of controlling shareholders.

For our empirical analysis, we utilize a firm-year panel data set of over 1,100 firms listed on the Chinese stock exchanges between 2001 and 2003. This time period provides a unique context to examine our research question. The OECD corporate governance practices were introduced into China in 2001. After 2003, Chinese firms were required by law to follow several OECD practices (e.g., firms must have a certain number of outside directors), and thus the variation of some dimensions of corporate governance across firms becomes too small for effective empirical tests after this date. We use fixed effects ordinary least square techniques to analyze the data, and we find empirical evidence to support our theoretical arguments.

Our study has important implications for public policy. Specifically, it suggests that regulatory authorities in emerging economies should reconsider the effectiveness of promoting all OECD-endorsed corporate governance practices. We find no empirical evidence supporting the effectiveness of board of directors or supervisory boards in alleviating expropriation costs of controlling shareholders.

Background and theory development

Controlling-shareholder expropriation and corporate performance

Controlling shareholders, by definition, have voting and control powers that allow them to make effective decisions that affect performance outcomes. Expropriation arises when controlling shareholders appropriate firm resources for themselves but jeopardize corporate performance and the interests of minority owners as a consequence. Controlling shareholders can undertake various forms of expropriation. First, instead of seeking talent in an open market (Fukuyama, 1992, 1995; Morck & Yeung, 2004), controlling shareholders often appoint unqualified and overpaid family members, friends, and political names to senior posts (Faccio et al., 2001; Su et al., 2007; Young et al., 2008). Second, controlling shareholders engage in self-beneficial trades by selling at below-market prices to, or buying at above-market prices from organizations that have special relations with them (Barclay & Holderness, 1989, 1991; Barclay, Holderness, & Pontiff, 1993; Chang & Hong, 2000; Khanna & Rivkin, 2001; Rajan & Zingales, 1998; Young et al., 2008). Third, controlling shareholders may advance personal, familial, and political agendas by, for instance, building a family-controlled empire instead of investing in R&D and other productivity enhancing activities (Backman, 1999; Young et al., 2008). Fourth, a common approach used in emerging economies is pyramid control. In the latter case, a few wealthy shareholders control top-tier holding companies, each of which controls several second-tier firms, and so on (Peng & Jiang, 2010). Research has shown that firm resources in lower-tier firms are often sacrificed to support firms at the top of the pyramid (Claessens et al., 2000; Morck, Wolfenzon, & Yeung, 2005).

One can capture the negative effects of controlling-shareholder expropriation on corporate performance directly or indirectly. The direct approach includes identifying expropriation activities of controlling shareholders and estimating their effects on corporate performance. However, this approach is often infeasible. As Dyck and Zingales (2004: 538) pointed out “a controlling party can expropriate value (of private benefit from control) for himself only when this value is not verifiable (i.e., provable in court). If it were, it would be relatively easy for non-controlling shareholders to stop him from expropriating it.”¹

The indirect approach often adopted in the corporate governance literature and also used in our study is to examine the relationship between ownership concentration (which is visible and measurable) and corporate performance (Ding, Zhang, & Zhang, 2007; Su et al., 2007; Heugens, van Essen, & van Oosterhout, 2009; Hu, Tam, & Tan, 2010).² Since a high level of ownership concentration can amplify controlling-shareholder expropriation (see below), the impact of ownership concentration on corporate performance can, to a great extent, capture the impact of controlling-shareholder expropriation on corporate performance.

With a high level of ownership concentration, controlling shareholders can more easily expropriate firm resources for their own benefit, which likely lowers firm performance. Pressure imposed by minority shareholders on controlling shareholders is weak; even if all minority shareholders formed a coalition, they might still have insignificant voting power and, therefore, no ability to prevent self-beneficial decisions by controlling shareholders (Su et al., 2007; Young et al., 2008). As a result, it becomes easier for controlling shareholders to pass proposals which induce appropriation of firm resources for their own objectives. Meanwhile, high ownership concentration enables controlling shareholders to effectively monitor and control the CEOs, or directly participate in management and board decisions. As a result, controlling shareholders are less likely to be opposed by the management team or board members.

In developed economies, controlling-shareholder expropriation can be largely counterbalanced by legal means and market mechanisms. For example, minority shareholders can confront controlling shareholders by resorting to legal protection of their property rights, and potential hostile takeovers also reduce the potential for controlling shareholders to pursue their own interests at the expense of overall corporate performance (Claessens et al., 2000). In emerging economies, however, weak legal and financial institutions make these options less effective. Worse, weak institutions may make controlling shareholders even more powerful. For instance, the top controlling families in a pyramid business group often have “super voting rights” (rather than “one share, one vote”); that is, their voting rights exceed their

¹ Two proxies of direct approach used in studies of developed countries are unavailable in our context. For instance, one can track privately negotiated transactions by controlling shareholders (Barclay & Holderness, 1989). However, such information is available only in countries with well developed stock markets and high transparency of financial disclosure. The other proxy, which does not exist in most emerging economies, is value differences among multiple classes of shares (DeAngelo & DeAngelo, 1985; Lease, McConnell, & Mikkelsen, 1984; Rydqvist, 1987).

² Other studies that use the indirect approach include Bertrand, Mehta, and Mullainathan (2002) and Selarka (2005) on India, Song, Ali, and Pillay (2007) on Malaysia, Bae, Kang, and Kim (2002) on South Korea, Delios, Wu, and Zhou (2006) and Sheu and Yang (2005) on Taiwan, and Mitton (2002) and Lins (2003) on Indonesia, the Philippines, Sri Lanka, Thailand, and others.

cash rights in the controlled affiliates (Almeida & Wolfenzon, 2006; Levy, 2009; Morck et al., 2005; Peng & Jiang, 2010). Since the controlling family shareholders are mostly interested in maximizing the profits of their directly controlled first-tier firms, they often appropriate the profits of the lower tier companies with their super voting rights. For example, after the onset of the Asian crisis in the late 1990s,

“United Engineers Malaysia, a healthy firm with strong growth prospects, bought out some management-controlled shares of its financially troubled parent, Renong Corporation, at artificially high prices. Both firms are controlled by the same family through a pyramid structure. The buyout directly transferred wealth to the family at the expense of minority shareholders of both firms” (Lemmon & Lins, 2003: 1447).

When ownership concentration is low, costs caused by controlling-shareholder expropriation will be relatively low, because small shareholders can form powerful coalitions that can effectively counterbalance the power of relatively large shareholders. However, the conventional problem of corporate governance arises: principal-agent conflicts and managerial expropriation (Jensen & Meckling, 1976). Dispersion of voting powers requires shareholders to appoint a commonly trusted agent (i.e., the CEO) to control corporate affairs, granting that agent significant power. In addition, dispersed ownership reduces incentives and abilities of the shareholders to monitor the behavior of the CEOs (Jensen & Meckling, 1976; Morck et al., 1988). As a result, the CEOs tend to seek perquisites and expropriate companies’ assets to benefit themselves (Demsetz & Lehn, 1985; Fama & Jensen, 1983; Johnson et al., 2000; Shleifer & Vishny, 1986).

Figure 1 summarizes the above arguments. As the level of ownership concentration increases from low to moderate, there are significant benefits associated with effectively reducing managerial expropriation. However, as ownership concentration continues to increase, those benefits will be eventually overshadowed by the costs related to controlling-shareholder expropriation. These arguments suggest that there is an optimal level of ownership concentration for corporate performance, somewhere between low and high, where overall expropri-

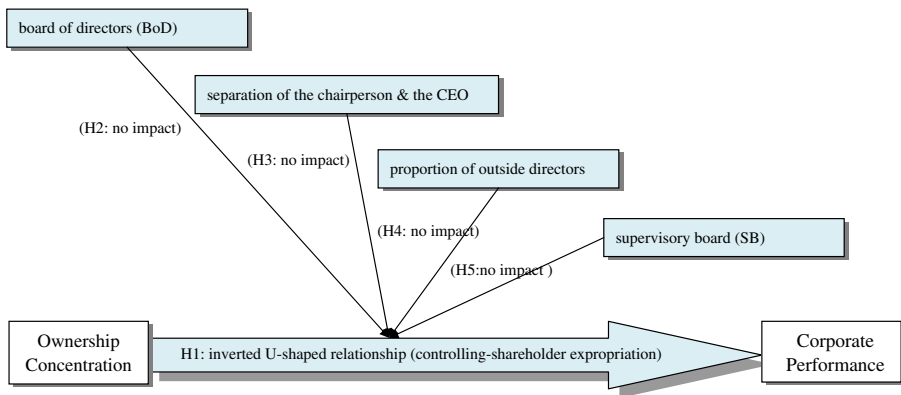


Figure 1 Controlling-shareholder expropriation and moderating effects of OECD-prescribed “good” corporate governance practices

ation (by both managers and controlling shareholders) is minimized. Hence, we propose the following hypothesis summarizing the relationship between ownership concentration and corporate performance:

Hypothesis 1 In an emerging economy with weak institutions, ownership concentration in a firm will have an inverted U-shaped effect (first increasing, and then decreasing) on corporate performance.

In many Asian emerging economies, such as Vietnam and China, firms have two types of controlling shareholders—state and private—as a result of privatization in the past decades (Backx, Carney, & Gedajlovic, 2002; Mok & Chau, 2003; O’Neill, Rondinelli, & Wattanakul, 2004; Sathye, 2005; Sun, Tong, & Tong, 2002). We argue that controlling-shareholder expropriation is salient no matter whether the controlling shareholder is the state or a private firm. As discussed earlier, the interests of private controlling shareholders lie in the profitability of their directly controlled first-tier firms in a pyramid ownership structure, and expropriation of the interests of lower-tier firms is therefore prevalent. In state-controlled companies, the state likely pursues socio-political objectives, such as employment and high wages, even at the expense of firm performance (Boardman & Vining, 1989; Shleifer & Vishny, 1994). To achieve its socio-political goals, the state might appoint politicians to the management team who are not skilled at commercial activities and have weak incentives to improve corporate performance (Boycko, Shleifer, & Vishny, 1996; Hart & Moore, 1990; Nellis, 2007; Shleifer, 1998; Su et al., 2007). We thus expect that in these emerging economies with weak institutions, ownership concentration in a firm will have an inverted U-shaped relationship to corporate performance, regardless of the status (state or private) of the controlling shareholder in a firm.

Moderating effects of OECD governance principles

As mentioned earlier, OECD corporate governance principles include an active board of directors (BoD), separation of the chairperson of the BoD and the CEO, majority of outside members on the BoD, and a two-tier board (i.e., a BoD plus a supervisory board overseeing the BoD) (OECD, 1999, 2004). Firms in emerging economies have been following the OECD principles of corporate governance, either required or recommended by local regulatory authorities (Jesover & Kirkpatrick, 2005; Lu & Batten, 2001; Peng, 2004). For example, firms, particularly those listed on a stock exchange, are required to construct a BoD to align the conflicts of interests among shareholders and other stakeholders, such as managers. In addition, firms are required to have outside directors to ensure board independence from executive members. For instance, Thailand requires a minimum number of outside directors. India and Singapore require a minimum fraction. Malaysia, Korea, and China require both (Abdullah, 2004; Dahya & McConnell, 2005; Lin, 2004; Peng, 2004). Although not required, decoupling the positions of the CEO and the chairperson of the BoD has been advocated by media and scholars in the region in order to further break down affiliations among executive members and improve board independence (Jesover & Kirkpatrick, 2005; OECD, 1999, 2004). In China, firms are also required to have a German-style two-tier board, using a supervisory

board to oversee the BoD (Lin, 2004; Peng, 2004; Yeh & Woidtke, 2005). We discuss below whether each of the corporate governance practices can mitigate the costs associated with controlling-shareholder expropriation.

Board of directors The BoD has been described as the most important part of corporate governance for its central role in corporate decision-making (Gevurtz, 2004; Hillman & Dalziel, 2003). To understand whether the BoD can counterbalance the power of controlling shareholders and attenuate expropriation activities of controlling shareholders, we first examine the bounden responsibilities of the BoD. The literature has recognized two major responsibilities that the BoD serves in improving firm performance. The BoD was first introduced as a key component of corporate governance to align the interests of shareholders and management to reduce agency costs arising from the separation of ownership and control (Fama & Jensen, 1983). Thus, the first responsibility of the BoD is to strengthen the power of shareholders to monitor and influence managerial decisions (Baysinger & Butler, 1985) and to minimize managerial expropriation (Finkelstein & D’Aveni, 1994), particularly in large firms with dispersed ownership. Extant studies have employed agency theory and stewardship or organization theory to explain this role of the BoD (Baysinger & Butler, 1985; Donaldson, 1990; Fama & Jensen, 1983; Finkelstein & D’Aveni, 1994). The second major responsibility of the BoD is to provide key external resources including legitimacy, advice and counsel, external funding, and links to other organizations (Pfeffer & Salancik, 1978; Williamson, 1988). The literature has used resource dependence theory and transaction cost theory to explain the resource provision role of the BoD (Pfeffer & Salancik, 1978; Williamson, 1988).

Given the well recognized responsibilities of the BoD in reducing managerial expropriation and providing external resources, it is highly questionable whether the BoD can effectively solve the conflicts between minority and controlling shareholders and mitigate expropriation by controlling shareholders. Moreover, using their super-voting rights, controlling shareholders can control the BoD (e.g., appoint and replace board members) and make the BoD a rubberstamp of the controlling shareholders (Berglöf, Rey, & Roell, 1997; Grossman & Hart, 1988; Su et al., 2007; Yeh & Woidtke, 2005; Young et al., 2008). Facing the risk of being replaced, board members do not have much power to veto decisions made by the controlling shareholders. Alternatively, the controlling shareholders may appoint those who they believe are likely to support their decisions to the BoD (Yeh & Woidtke, 2005). The controlling shareholders may even make important corporate decisions without consulting the BoD. A recent corporate scandal in India illustrates this point: Ramalinga Raju, the founder and the single controlling shareholder of Satyam Computer Systems (India’s fourth largest IT company), made a decision without any discussions with the other BoD members on two large acquisitions of real estate companies controlled by his sons (Tripathi, 2009). In summary, the BoD’s ability to attenuate controlling-shareholder expropriation is limited. Stated formally:

Hypothesis 2 In an emerging economy with weak institutions, an active board of directors will not attenuate the negative effect of high ownership concentration on corporate performance.

Separation of the chairperson and the CEO Similar to our discussion of the roles of the BoD, we examine the purposes and benefits of separating the chairperson and the CEO in a company. On the one hand, separation of the two positions allows the BoD to be more independent and can thus better challenge the CEO when managerial expropriation takes place (Mallette & Fowler, 1992; Peng, Zhang, & Li, 2007). On the other hand, separation of the two positions may jeopardize the unity of command and the clarity of decision-making authority at the top of the firm (Donaldson, 1990; Finkelstein & D'Aveni, 1994). This perspective focuses on conflicts between the BoD and the CEO, which is not the core conflict in corporate governance in emerging economies. When the controlling shareholders dominate the control of corporate affairs and are responsible for appointing and replacing the CEO and the chairperson of the BoD, duality of the two positions is not likely to have any significant impact on mitigating expropriation by the controlling shareholders. Therefore, we propose the following hypothesis:

Hypothesis 3 In an emerging economy with weak institutions, separation of the chairperson and the CEO will not attenuate the negative effect of high ownership concentration on corporate performance.

Outside directors Outside directors are members on the BoD who hold no other positions in the same firm (Johnson, Daily, & Ellstrand, 1996; Lin, 2004; Peng, 2004). Outside directors are considered a component of good corporate governance practice for two reasons following the BoD's major two responsibilities: first, relative to inside directors, outside directors are more independent from the management and can thus better monitor the senior management team and address managerial expropriation (Byrd & Hickman, 1992; Peng, 2004; Rosenstein & Wyatt, 1990); second, outside directors likely have more connections with external organizations and can provide more external resources (Hillman & Daziel, 2003; Peng, 2004). However, no evidence has shown that outside directors are less likely to collude with controlling shareholders, or that they are more able to thwart expropriation activities by controlling shareholders. Indeed, we argue that outside directors are not useful in attenuating controlling-shareholder expropriation in emerging economies.

In emerging economies, where inter-firm cross-shareholdings are prevalent (e.g., widely adopted pyramid business groups) (Claessens et al., 2002; Claessens et al., 2000), outside directors may not be truly independent of the controlling shareholders. Outside directors may be affiliated with the controlling shareholders even if they hold no other positions in the firm (Peng, 2004). For instance, they may hold senior positions in related firms in the same business group (Fich, 2005). Such outside directors, with their affiliation with the controlling shareholders, cannot serve as an effective force to mitigate expropriation of the controlling shareholders. Furthermore, in countries such as China (our empirical context) where the government is heavily involved in economic development, firms tend to seek current or former politicians to serve as outside directors in order to build close relationships with the government (Peng, 2004; Tian & Lau, 2001).

These outside directors arguably care less about corporate performance and the interests of minority shareholders and more about their own socio-political objectives. We therefore conclude that outside directors are not likely to ameliorate the negative effect of controlling-shareholder expropriation on firm performance:

Hypothesis 4 In an emerging economy with weak institutions, outside directors will not attenuate the negative effect of high ownership concentration on corporate performance.

Supervisory board OECD principles suggest that a two-tier board structure, which is used by firms in Germany, the Netherlands, and Denmark, represents a good corporate governance practice because it separates management boards from supervisory boards, thereby diversifying control of corporate affairs and balancing the power of insiders (Franks, Mayer, & Wagner, 2006; Maassen & van den Bosch, 1999; Melis, 2000). In Germany in particular, the supervisory board plays a crucial role in corporate governance, including appointing and dismissing BoD members, and codetermining corporate decisions (Commission of the German Corporate Governance Code, 2010).

Among Asian emerging economies, China is the only country that requires listed companies to set up supervisory boards (SBs) whose main duty is to oversee the BoD (Dahya, Karbhari, Xiao, & Yang, 2003; Firth, Fung, & Rui, 2007; Yeh & Woitke, 2005). China’s *Company Law*, enacted into force in 1993, prescribes that the SB should exclude the BoD members and senior executives such as the CEO and the CFO, and that it should have at least one employee representative elected by the employees, and at least one minority shareholder representative (Firth et al., 2007). In January 2001, the China Securities Regulatory Commission (CSRC) published *The Code of Corporate Governance for Listed Companies in China* (hereafter referred to as *The Code*), which requires firms to include independent professionals in accounting and law in the SB so as to monitor firms’ corporate finance and accounting disclosure (Firth et al., 2007).

However, we expect that Chinese SB’s effectiveness in attenuating the controlling-shareholder expropriation is limited, because it has weaker power and lower status relative to the BoD in a firm. In Germany, SB is defined by law as the first-tier board whose fiduciary legal duty is to appoint and dismiss members on the BoD (Kaplan, 1994). Differently, in China, although supervisory directors are allowed to attend and voice their opinions at BoD meetings, they are a second-tier board and cannot vote on decisions made by the BoD. Nor does it have any power to select members on the BoD (Cheng, 2000; Dahya et al., 2003; Xiao, Dahya, & Lin, 2004). Another important difference between SBs in Germany and in China is that most members in the German SBs usually hold either crucial senior positions within firms or important external positions (e.g., executives in a firm’s major bank creditor) (Franks & Mayer, 2001; Franks et al., 2006). In contrast, supervisory directors in China often hold marginal positions in a firm (Xiao et al., 2004). This discussion suggests that when the BoD represents the interests of controlling shareholders, the role of SB members will be limited in counteracting the power of

the BoD and controlling shareholders. Thus, we do not expect the SB to mitigate the negative impact of controlling-shareholder expropriation on corporate performance in China:

Hypothesis 5 In an emerging economy with weak institutions, an active supervisory board will not attenuate the negative effect of high ownership concentration on corporate performance.

Figure 1 summarizes our above discussions: first, ownership concentration has an inverted U-shaped relationship to corporate performance; second, the BoD, separation of the chairperson and the CEO, outside directors, and the SB have no moderating effects on the inverted U-shaped relationship.

Method

Data

China represents a good empirical setting to test our theory because it has all the necessary characteristics we need: a weak institutional system in terms of limited legal protection of property rights and an underdeveloped financial market (Xu & Wang, 1999), high ownership concentration of firms (Xu & Wang, 1999), co-existence of state- and privately-controlled firms (Delios et al., 2006; Xu & Wang, 1999), prevailing pyramidal control (Ma & Lu, 2005), and the adoption of a two-tier board (Dahya et al., 2003; Lin, 2004).

We retrieved the firm-year data of all publicly listed companies between 2001 and 2003 on the Shenzhen Stock Exchange and the Shanghai Stock Exchange, the two stock exchange markets in China, from the SINOFIN database compiled by the China Centre for Economic Research at Peking University. The time period we selected begins in 2001, when *The Code*, the first OECD-style corporate governance codebook, was introduced by the CSRC (CSRC, 2001). Our time period ends in 2003, after which some of the codes, such as a minimum fraction of outside directors, were written into the law and became mandatory (Peng, 2004), and consequently the variation of corporate governance structures across firms became too small for empirical tests.

The SINOFIN database contains 1,200, 1,269, and 1,257 firms for 2001, 2002, and 2003, respectively. The database details the historical misconduct of firms charged by the CSRC. Accordingly, we deleted observations which were reported by the CSRC to contain severe fabrications and falsifications of financial information. After further deleting the missing values, we obtained an unbalanced panel data sample with information for over 1,100 firms during 2001–2003 (1,160 firms in 2001, 1,231 in 2002, and 1,241 in 2003). We present the sample distribution by industry (according to the CSRC's industry classification) and by region in Tables 1 and 2. The tables show that Chinese listings are mainly concentrated in the manufacturing sectors and in the East and Central-South regions.

Table 1 Sample distribution by industry.

Industry	2001		2002		2003	
	Num. of Firms	Freq.	Num. of Firms	Freq.	Num. of Firms	Freq.
(1) agriculture, forestry, livestock farming, and fishery	27	2.33	29	2.36	30	2.42
(2) mining	16	1.38	18	1.46	20	1.61
(3) manufacturing	680	58.62	709	57.60	706	56.89
(4) electric power, gas and water production and supply	47	4.05	50	4.06	52	4.19
(5) construction	17	1.47	23	1.87	23	1.85
(6) transport and storage	46	3.97	55	4.47	55	4.43
(7) information technology	61	5.26	78	6.34	80	6.45
(8) wholesale and retail trade	94	8.10	93	7.55	88	7.09
(9) finance and insurance, real estate, social service, and communication and cultural industry	92	7.93	95	7.72	103	8.30
(10) comprehensive	80	6.90	81	6.58	84	6.77
Total	1,160	100	1,231	100	1,241	100

Variables and measurement

Dependent variable We measured *corporate performance* using return on assets (ROA). A firm’s ROA in year t is measured as the ratio of its net income to average total assets in year t . ROA is one of the most widely used accounting-based measures of performance, and captures how much profit a firm generates by deploying all its

Table 2 Sample distribution by region.

Region	2001		2002		2003	
	Num. Of Firms	Freq.	Num. Of Firms	Freq.	Num. Of Firms	Freq.
East (Jiangsu, Zhejiang, Anhui, Fujian, Jiangxi, Shangdong, & Shanghai)	404	34.83	442	35.91	447	36.02
North (Inner Mongolia, Hebei, Shanxi, Beijing, & Tianjin)	155	13.36	164	13.32	162	13.05
Northeast (Liaoning, Jilin, & Heilongjiang)	119	10.26	118	9.59	123	9.91
Northwest (Ningxia, Xinjiang, Shanxi, Gansu, & Qinghai)	79	6.81	87	7.07	86	6.93
Central South (Henan, Hubei, Hunan, Guangdong, Guangxi, & Hainan)	282	24.31	296	24.05	297	23.93
Southwest (Tibet, Sichuan, Guizhou, Yunnan, & Chongqing)	121	10.43	124	10.07	126	10.15
Total	1,160	100	1,231	100	1,241	100

corporate resources (Bettis, 1981; Burton, Lauridsen, & Obel, 2002; Dess & Robinson, 1984; Eisenberg, Sundgren, & Wells, 1998). We did not use stock-based measures of firm performance such as Tobin's Q (Lang & Stulz, 1994; Mehran, 1995; Servaes, 1991) or post-IPO stock price performance (Jain & Kini, 1994; Jaskiewicz, González, Menéndez, & Schiereck, 2005). This is because capital markets in China are underdeveloped with strong information asymmetry between investors and companies and thin floating proportions, and hence stock prices in China do not necessarily reflect a firm's fundamental performance (Lin & Swanson, 2008; Peng, 2004). In addition, due to information asymmetry, public investors in emerging economies are speculative and thus very sensitive to short-term price volatility (Lin & Swanson, 2008). Therefore, in China, accounting-based measures such as ROA can better capture a firm's fundamentals than stock-based measures.

Explanatory variables We measure *ownership concentration* as the cumulative percentage of shareholdings by the ten largest shareholders in a company. As shown in the robustness checks reported below, we also use alternative measures including cumulative percentage of shareholdings by the five largest shareholders, and Herfindahl measures for largest five and ten shareholders. *State control* is a dummy variable with value one if the ultimate controlling shareholder is the state and zero if it is a private shareholder. Following existing literature (Vafeas, 1999), we used *frequency of BoD meetings* adjusted by yearly mean³ to capture whether a BoD of a firm is active and vigilant relative to the BoDs of other firms in the same year. Specifically, we first calculate the logarithm of the BoD meeting frequencies of a firm and then deducted the mean value of the logarithm of the BoD meeting frequencies of all firms in the same year. Similarly, we use *frequency of SB meetings* adjusted by yearly mean to measure the extent to which a firm is active and vigilant in its SB activities relatively to other firms. *Separation of the chairperson and the CEO* is a dummy variable with value one if the chairperson of the BoD and the CEO are different people and with value zero if they are the same person. *Proportion of outside directors* is measured as a firm's ratio of the number of outside directors to the total number of directors on the BoD minus the yearly mean.

To reduce a potential endogeneity concern, we used a one-year lag for the ownership structure and corporate governance variables (Bhagat & Black, 2002; Greene, 2008). Accordingly, our regressions use ROA values in 2002 and 2003 and independent variables in 2001 and 2002.

Control variables At firm level, we control for *firm size* (the logarithm of total assets), *leverage* (the ratio of total debt to total equity), *BoD size* (the logarithm of the number of the BoD members), and *SB size* (the logarithm of the number of SB members), all of which were lagged one year in the regressions.

At the industry level, we specify *industry performance* as the ratio of total net profits to total average assets of an industry minus the average ratio of all ten industries in the same year. We also employ a regional level control variable, *regional performance*, which is measured as the ratio of total net profits to total average assets in a region minus the average ratio of all six regions in the same year.

³ The mean is based on all sample firms, and same hereafter.

Table 3 Descriptive statistics and correlation matrix.

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
(1) ROA	1.0000													
(2) ownership concentration	0.0707**	1.0000												
(3) BoD meeting freq	-0.0675***	-0.0619***	1.0000											
(4) separation of chairperson and CEO	0.0058	0.0121	0.1308**	1.0000										
(5) proportion of outside directors	-0.0012	-0.0132	0.3383**	0.0086	1.0000									
(6) SB meeting freq	-0.0390	-0.0236	0.6747**	0.1179**	0.3177**	1.0000								
(7) state-control	0.0458	0.1171**	-0.0900**	0.0266	-0.1160**	0.0103	1.0000							
(8) BoD size	-0.0100	0.0753**	-0.0786**	0.1532**	-0.1350**	-0.0062	0.1083**	1.0000						
(9) SB size	0.0021	0.0636**	-0.0655**	0.0599**	-0.0865**	0.0380	0.1304**	0.2928**	1.0000					
(10) firm size	0.0183	0.1304**	0.0119	0.0124	-0.0543**	-0.0080	0.0440**	0.0776**	0.1014**	1.0000				
(11) leverage	0.0233	-0.0399	0.0340	0.0230	-0.0094	0.0262	0.0027	-0.0253	0.0069	0.0000	1.0000			
(12) industry performance	0.0712**	0.1933**	-0.0636**	0.0194	-0.0561**	-0.0538**	0.1227**	0.0445	0.1213**	0.0747**	-0.0463	1.0000		
(13) regional performance	0.0521	0.0746**	-0.0173	0.0484	0.0104	-0.0193	0.0580**	0.0006	-0.0218	0.0518	0.0052	-0.0043	1.0000	
(14) year dummy	-0.0282	-0.0083	0.0000	-0.0088	0.0000	0.0000	0.0965**	0.0000	0.0000	-0.0172	0.0113	0.0000	0.0000	1.0000
Mean	-0.0027	0.6117	0.0000	0.3830	0.0000	0.0000	0.8200	0.0000	0.0000	2.6090	0.0144	0.0000	0.0000	0.3194
Std. Dev	0.3393	0.1280	0.5377	0.4862	0.0911	0.4537	0.3843	0.2399	0.3129	11.9807	0.0613	0.0126	0.0089	0.4663

** $p < 0.01$.

Table 4 Fixed effect panel ordinary-least square regression results.

Models	General	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	All
			State-Control		Freq of BoD Meetings	Separation of Chairperson and CEO	Proportion of Outside Directors	Freq Of SB Meetings					
concentration	0.1016	1.0713**	1.0411**	2.8202	1.0611**	0.7993*	1.0488**	1.0139**	1.0655**	1.0190**	1.0661**	0.8460**	1.5034
concentration ²		-1.0027**	-1.0769**	-3.424	-0.9863**	-0.8008**	-0.9747**	-0.8217+	-1.0101**	-0.9579**	-0.9811**	-0.8126**	-2.1889
state-control			-0.1756	0.2201									-0.1106
state-control)*concentration				-2.7887									-1.4406
state-control)*concentration ²				3.4635									2.2755
freq of BoD meetings					-0.0071	-0.3358+							-0.3892
freq of BoD meetings*concentration					0.968								1.172
freq of BoD meetings*concentration ²						-0.6696							-0.8216
separation of C&C							0.0506	0.1078					0.1064
separation of C&C*concentration								0.2073					0.1925
separation of C&C*concentration ²								-0.4693					-0.4532
proportion of OD									0.2028	0.3997			0.6386
proportion of OD*concentration										1.804			1.0477

Finally, we include a year dummy, taking a value of one for 2001 and zero for 2002.⁴

Estimation strategy

We utilize a fixed-effect panel ordinary least squares (OLS) model to test our theory, in which firm-specific residuals are controlled for (Greene, 2008). To test the inverted U-shape of the relationship in Hypothesis 1, we incorporate both *ownership concentration* and *ownership concentration*² in the regressions, where a negative estimation parameter for *ownership concentration*² implies the existence of controlling-shareholder expropriation. To examine the moderating effects of corporate governance practices as specified in Hypotheses 2 to 5, we interacted each corporate governance variable with both *ownership concentration* and *ownership concentration*². A significantly positive parameter for the interaction between the corporate governance variable and *ownership concentration*² suggests the effectiveness of this corporate governance practice in alleviating controlling-shareholder expropriation. We employed Hausman tests, which suggest that fixed-effects models are preferred to random-effects models. Huber-White Sandwich Robust estimators for standard deviations are used to address potential heteroskedasticity problems (White, 1982).

Results

Comparing corporate governance of firms in 2001 and 2002 indicates that on average firms adopt better corporate governance practices according to OECD principles: specifically, the number of firms that separated chairperson from the CEO increased by about 40, and the average proportion of outside directors increased significantly from 5.53% to 22.24%. Table 3 reports descriptive statistics.

Regression results

We use a step-by-step strategy for our regressions. We first include only control variables in our regression on ROA. We then add the squared term of ownership concentration and the corporate governance variables. Finally, we add the interactions of each corporate governance variable with the ownership concentration variables. Table 4 presents the regression results. Overall, all our hypotheses receive empirical support.

First, our results support Hypothesis 1. Specifically, ownership concentration has an inverted U-shaped relationship to corporate performance. Results in all steps consistently show that ownership concentration has a significant positive effect on ROA, whereas the squared term of ownership concentration has a significant negative effect on ROA. The negative effect of the squared term provides evidence

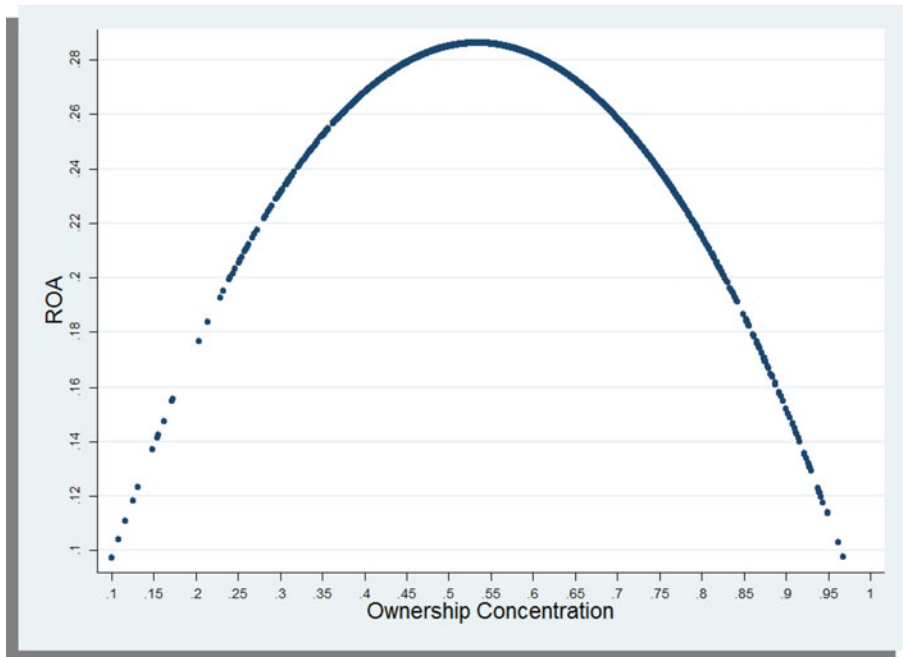
⁴ Because independent variables are lagged one-year, we have only two periods in the regressions. Therefore, here by “2001,” we mean independent variables take values in year 2001 and dependent variables take values in year 2002; similarly, by “2002,” we mean independent variables take values in year 2002 and dependent variables take values in year 2003.

for the existence of controlling-shareholder expropriation. Figure 2, based on the regression results in Model 2, illustrates the inverted U-shaped relationship. A firm’s ROA increases with an increasing ownership concentration from 0% to approximately 48%, after which higher ownership concentration results in a lower ROA. Results for Models 3 and 4 suggest that there is no significant difference in the relationship between ownership concentration and ROA when the controlling ownership is state or private.

Second, Models 5–13 support our hypotheses about the ineffectiveness of the BoD, separation of the chairperson and the CEO, outside directors, and the SB to moderate the inverted U-shaped impact of ownership concentration on corporate performance. Specifically, none of the interactions between those four corporate governance variables and the squared term of ownership concentration is statistically significant.

Some results for the control variables are worth discussing. Specifically, firm size has a significantly negative impact on ROA. Industrial and regional performances have significantly positive impacts on ROA. Neither the BoD size nor the SB size has any significant effect. BoD and SB meetings both have negative effects on corporate performance, implying that the costs associated with high-frequency meetings (e.g., time, travel expenses, and meeting fees) outweigh the benefits in terms of strategic decision making and monitoring of management.

Robustness check Because our focus is on expropriation by the controlling shareholder, and it is more severe when ownership concentration is high, we replicate the regressions



Note: Sample simulation based on estimation results in Model 2 of Table 4.

Figure 2 Relationship between ownership concentration and return on assets

using a subsample with relatively high ownership concentration. Thus, we examine how the corporate governance variables affect the “downward sloping” pattern of the inverted U-shaped curve. Based on the regression results in Table 4, we find that the optimal level of ownership concentration is between 47% and 48%. We then include only observations with ownership concentration higher than 48% in the subsample. Table 5 reports the results, which are consistent with our main regression results in Table 4. First, ownership concentration has a significant negative effect on corporate performance for firms whose ownership concentration is high. Second, none of the OECD “good” corporate governance practices significantly mitigates the negative effect of ownership concentration on corporate performance.

In addition, we use alternative measures for ownership concentration in the full sample, as well as the subsample with high ownership concentration. We specify two Herfindahl measures, calculated as the sum of the square of shareholding percentage by each of the largest ten (or five) shareholders. We also use the cumulative shareholding percentage of the largest five shareholders. Regardless of the concentration measure we used, we obtain similar results: first, a concentration measure has an inverted U-shaped relationship with the ROA; second, none of the OECD “good” corporate governance variables moderates the inverted U-shaped. These additional tests added robustness to our empirical findings.

Discussion

Our paper examines a fundamental question in corporate governance in Asia: do OECD-prescribed good practices of corporate governance alleviate the problem of controlling-shareholder expropriation—the major concern of corporate governance in these economies? Our study represents the first in the literature to evaluate the effectiveness of corporate governance practices from a principal-principal perspective, which is emerging as the most relevant perspective for studying corporate governance in emerging economies (Young et al., 2008). We find that in China, *none* of the “good” practices prescribed by the OECD (including an active BoD, separation of the chairperson and the CEO, a large proportion of outside directors, and an active SB) is effective in attenuating the negative consequences of controlling-shareholder expropriation on corporate performance.

Our study has important implications for government policy in emerging economies. Our findings suggest that simply requiring firms to adopt the OECD-prescribed corporate governance practices will not necessarily lead to better corporate governance. Regulatory authorities in emerging economies should be aware that most OECD corporate governance practices are not designed to solve the conflicts between controlling and minority shareholders. Indeed, regulatory authorities in emerging economies may need to develop new practices to deal with the unique features of corporate governance in emerging economies. In particular, they should focus on improving the true independence of board directors and the monitoring power of supervisory directors in order to address controlling-shareholder expropriation and enhance the quality of corporate governance. Emerging economies should improve their legal and financial market infrastructures so that minority owners can resort to legal means and financial market mechanisms to protect their interests.

Table 5 Subsample fixed effects panel ordinary-least square regression results. (Only observations with ownership concentration > 48.00%).

Models	General		State-Control		Freq of BoD Meetings			Separation of Chairperson and CEO		Proportion of Outside Directors		Freq Of SB Meetings		All
	(14)	(15)	(16)	(17)	(18)	(19)	(20)	(21)	(22)	(23)	(24)	(25)		
concentration	-0.2852*	-0.2825*	-0.2112	0.0665	-0.2616+	-0.2595+	-0.3975*	-0.2510+	-0.2473+	-0.2599+	-0.2603+	-0.3035		
state-control			0.059									0.0653		
state-control*concentration		-0.0114	-0.1017									-0.1004		
freq of BoD meetings				0.0277	0.0821							0.102		
freq of BoD meetings*concentration					-0.0844		-0.1982					-0.1089		
separation of C&C						0.0002	0.3031					-0.1942		
separation of C&C*concentration												0.2984		
proportion of OD								-0.0416	-0.3324			-0.325		
proportion of OD*concentration									0.4468			0.4196		
freq of SB meetings										0.0038	0.001	-0.0104		
freq of SB meetings*concentration											0.0043	0.0104		
BoD size				-0.1076	-0.1069	-0.1069	-0.1068	-0.1045	-0.1044	-0.1066	-0.1066	-0.1042		
SB size				-0.1828	-0.1827	-0.1839	-0.185	-0.1855	-0.1854	-0.1844	-0.1844	-0.1851		
firm size	-0.0201	-0.02	-0.0201	-0.0159	-0.0162	-0.0164	-0.0159	-0.0168	-0.0164	-0.0163	-0.0163	-0.016		
leverage	0.1539	0.1538	0.1538	0.1738	0.1741	0.1715	0.175	0.1697	0.1677	0.1722	0.1722	0.1729		
industry performance	2.1580+	2.1615+	2.1667+	1.9036	1.9034+	1.9404+	1.9091	1.9458+	1.9679	1.9415+	1.9418+	1.8992		
regional performance	1.0789	1.0813	1.0764	1.455	1.4506	1.4063	1.3696	1.4211	1.4261	1.4056	1.405	1.4367		
year dummy	0.0161	0.0165	0.0165	0.0213	-0.0078	-0.0094	-0.0094	-0.0101	-0.01	-0.0092	-0.0092	-0.0085		
constant	0.1328	0.1371	0.0911	0.4423	0.2139*	0.2178*	0.3070**	0.2143*	0.2107*	0.2175*	0.2177*	0.242		
number of observations	1873	1873	1873	1873	1873	1873	1873	1873	1873	1873	1873	1873		
number of groups	993	993	993	993	993	993	993	993	993	993	993	993		
R-square	0.011	0.011	0.011	0.027	0.0271	0.0259	0.0271	0.0261	0.0263	0.0259	0.0259	0.0288		

+ $p < 0.1$, * $p < 0.05$, ** $p < 0.01$.

Dependent variable is return on assets (ROA).

One natural extension of our study is to replicate it in other emerging economies having weak institutional systems, high ownership concentration, and prevailing pyramidal control. Another more important possible extension is to revisit corporate governance theories from a principal-principal perspective, and to identify corporate governance practices that can effectively address controlling-shareholder expropriation. Finally, the emergence of more effective external institutions may also alter the impact of internal governance mechanisms, and identification of those institutions should provide another fruitful area for future research.

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