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CORPORATE GOVERNANCE AND NATIONAL INSTITUTIONS: A REVIEW AND EMERGING RESEARCH AGENDA

Abstract

We present a critique of corporate governance research grounded in agency theory and propose that cross-national comparison of corporate governance should consider how the nature and extent of agency relationships differ across different institutional contexts. Building on prior governance studies grounded in sociology and organizational theory we argue that performance outcomes of boards of directors, ownership concentration and executive incentives may differ depending on the legal system and institutional characteristics in a specific country. Institutions may also affect the extent of complementarity/substitution among different firm-level governance practices producing patterned variations in firm-level governance mechanisms. Our discussion suggests that researchers need to develop more holistic, institutionally embedded governance framework to analyze organizational outcomes of various governance practices.

Introduction

The last decade has witnessed an explosion in studies of corporate governance around the world, including Asia. Much corporate governance research has been inspired by ideas from agency theory (e.g. Eisenhardt, 1989) and related normative, empirical and policy debates. The central premise of agency theory is that managers as agents of shareholders (principals) may engage in self-serving behavior that can be inconsistent with the shareholders' wealth maximization principle (Shleifer & Vishny, 1997). To constrain managerial opportunism, shareholders may use a diverse range of corporate governance mechanisms, including monitoring by boards of directors (e.g., Fama & Jensen, 1983) or large outside shareholders (e.g., Demsetz & Lehn, 1985; Holderness & Sheehan, 1988). In addition, equity-based managerial incentives may help align the interests of agents and principals (Jensen & Murphy, 1990; Murphy, 1985, 1997). Finally, managerial opportunism can be constrained by external markets, such as the threat of takeover (e.g., Grossman & Hart, 1988), product competition (Hart, 1983; Jensen, 1993), and managerial labor markets (Fama, 1980).

These concepts from agency theory have informed a growing number of attempts to understand cross-national differences in corporate governance. However, such approaches remain problematic because institutions modify the basic principal-agent relationship in ways that require specific contextualization. Institutions matter for corporate governance because these create different sets of incentives or resources for monitoring, as well as embody different sets of values and normative understandings about the nature of the firm. The specific conditions of the "Anglo-Saxon model" constitute the exception rather than the rule when looking at Continental Europe, East Asia, India and emerging economies in other regions. In most countries, ownership is substantially more concentrated. Legal institutions differ widely, as do managerial career patterns and the salience of social norms around

shareholder value. As Globerman, Peng, & Shapiro (2011:1) indicate: “One needs to understand the institutional framework in which organizations operate in order to understand the rationale for and consequences of specific corporate governance models, as well as the likelihood that specific governance reforms will be adopted and prove effective.”

While previous studies have brought institutional theory to bear on questions of corporate governance, the comparative understanding of institutions has remained surprisingly thin (see also Jackson & Deeg, 2008). Given the ‘under-contextualized’ nature of corporate governance research, a challenge remains to more explicitly understand and compare how the effectiveness of different corporate governance mechanisms varies across different organizational environments and institutional contexts (Aguilera, Filatotchev, Gospel, & Jackson, 2008). Effectiveness may involve not only the protection of investors’ wealth, as in agency theory, but also fostering creation of new wealth and the fair distribution of wealth among stakeholders.¹ The effectiveness of corporate governance practices depends on both their fit with the task environment of the organization (Thompson, 1967) and their legitimacy within wider sets of institutions that differ across societies and over time (Dobbin 1994; Fligstein 2001; Roy, 1997; Scott, 2003). These literatures advocate moving away from the focus on principals and agents as a universal phenomenon, and looking at the patterned variation of corporate governance in different settings.

In this Perspectives paper, we outline an emergent stream of research which argues that understanding how corporate governance differs around the world, including the Asia Pacific, requires a more rich and comparative view of institutions. In particular, the effectiveness of well-known corporate governance practices differs across countries due to broader sets of complementarities among institutions within the particular social and political environment. In developing our arguments, we do not attempt to present a comprehensive

¹ We see this context-specific view of effectiveness as distinct from agency theory, which often assume that these different elements are combined into a single long-term organizational objective of increasing shareholder value (see Jensen, 2002).

review of empirical results based on comparative corporate governance research. Likewise, we do not attempt to systematically elaborate a theory of how institutions shape the effectiveness of corporate governance. Rather, we develop a set of theoretically grounded illustrations of how effectiveness is influenced by institutions with the objective of inspiring and informing an emerging comparative research agenda.

Specifically, we illustrate how performance effects of corporate boards, ownership concentration and executive incentives may differ according to the legal system and institutional characteristics in a specific country. Institutions may also affect the extent of complementarity or substitution among different firm-level governance practices. Our discussion suggests that researchers need to develop a more holistic and institutionally embedded theoretical understanding of corporate governance to analyze the organizational outcomes of various governance practices. The contribution of this perspective is to go beyond more universalistic approaches, which apply models such as agency theory in the same universal manner in different institutional settings. As such, we contribute to emerging attempts to integrate institutional theory within corporate governance research (e.g., Aguilera et al., 2008; Aguilera & Jackson, 2003).

From the Principal-Agency Dichotomy towards a Comparative Institutional Analysis of Corporate Governance

The principal-agency framework dominates research on corporate governance. Here the efficiency of various corporate governance mechanisms is studied from the perspective of shareholders, who invest resources and seek maximum return on their investment. This approach has emphasized the role of self-interested opportunism and “arm’s-length” contracting between shareholders and managers (Bruce, Buck, & Main, 2005). For example, well-designed incentive schemes should increase corporate productivity and value by better aligning top managers’ interests with those of shareholders (Hall, 2003). Corporate

governance is thus conceptualized as a set of organizational practices aimed at monitoring and, if needed, restraining managerial discretion.

The principal-agent relationship is often assumed to be universal and endemic to all forms of corporate organization. Nonetheless, empirical research has cast doubt on whether a clear universal link exists between these corporate governance mechanisms and firm performance (e.g., Dalton et al, 2003). For example, studies of executive pay in the US have focused on the hypothesis that agency problems can be solved by strengthening incentives linking CEO pay and performance (Hall, 2003), despite continued controversy over the empirical evidence (see Bebchuk & Fried, 2004; Kaplan, 2008; Wyld & Maurin, 2008). Comparative research has stressed the weaker effects of equity-based incentives in the UK and Germany (Bruce et al., 2005) or the absence of a link between high pay for performance sensitivity in executive pay and financial performance in Japan (Kubo, 2005). Cross-nationally comparative research has therefore also further sensitized researchers to how different sets of institutions modify the basic principal-agent relationship by providing different sets of incentives, resources, and understandings of corporate governance. While a large literature has debated the strengths and weaknesses of agency theory, we highlight two issues relevant for cross-national comparisons.

A first critique argues that agency theory is an ‘under-socialized’ approach that remains insensitive to how institutions shape the identities, interests and interactions among actors in corporate governance (Aguilera & Jackson, 2003). Agency theory has restricted its attention to mostly two actors (shareholders and managers).² Here institutions have played a relatively limited role. For example, legal systems are argued to offer different levels of investor protection and thereby influence the level of agency costs faced by shareholders in different countries (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Sociological

² Stewardship and stakeholder theories remove some restrictive assumptions of the agency approach, yet do not provide a comprehensive research framework that links corporate governance with the broader context of different institutional environments (Aguilera et al., 2008; Yoshikawa & Phan, 2001).

strands of institutional theory go further to provide an alternative explanation for firm behavior in terms of “understandings that organizational actors share, independent of their interests” (DiMaggio & Powell, 1983: 3). Rather than making predictions based on self-interested actors with bounded rationality, institutional theory identifies regulative, normative and cognitive mechanisms that shape the identities and interests of a wider set of stakeholders. Different stakeholders may build coalitions to select and adapt socially legitimate and institutionally available corporate governance practices (Aoki, 2001). For example, the agency conflict takes on very different forms across countries not only due to the different patterns of shareholder concentration but based on the different social identities of blockholders such as families, the state, banks, foundations or business groups (Jackson, 2010). Institutional theories have moved beyond the focus on how the law shapes agency conflicts, and looks now at how wider cultural, social, and political factors shape the cross-national diversity of actors and settings in corporate governance (for a comprehensive review, see Aguilera & Jackson, 2010).

A second and closely related point is that the notion of effectiveness within agency theory is too narrow to be applied to corporate governance in very different settings. In fact, the effectiveness of different corporate governance practices depends strongly on their fit with the broader organizational environment (Aguilera et al., 2008). The strategic salience of resources differs across organizations and creates different demands on governance. For example, corporate governance performs very different functions across the life cycle of an organization and helps to explain the different salience of certain practices between different types of firms (Filatotchev, Toms & Wright, 2006). The alternative ‘open-system’ approach suggests that corporate governance practices are interdependent with the diversity, fluctuations, and uncertainties of their environment, and rejects universalistic ‘context-free’ propositions (see Aguilera et al., 2008). The incentives and resources available for

monitoring are constituted in relation to particular institutional settings, which also shape managerial behavior through shared cognitions and norms. Here corporate governance practices are effective only in relation to a wider configuration of organizational variables—thus shifting the focus of corporate governance research toward a more holistic context of wealth creation and protection, rather than only agency costs.³

In understanding the contingent nature of effectiveness in corporate governance, the concept of institutional complementarities offers a way to understand how various corporate governance elements may work more effectively in certain combinations and thus give rise to institutionally diverse forms (Aoki, 2001; Schmidt & Spindler, 2004). For example, as we discuss later in the paper, executive compensation may be an effective incentive alignment mechanism, but only when supported by a vigilant and independent board. By enabling and constraining different coalitions among stakeholders, corporate governance institutions may also yield comparative advantages for certain types of organizations at the expense of others. Furthermore, complementarities within a given institutional context may also be a source of path-dependence, where organizations are locked-in to certain sets of governance arrangements and may have difficulty in switching to alternative ways of organizing (Sydow, Schreyögg & Koch 2009). Therefore, the appropriateness and effectiveness of the specific mechanism may depend on the institutional context within which the firm operates and the extent of their conformity to the legitimized norms and expectations prevailing in that market.

Table 1 provides a summary of the main points of departure between mainstream agency-based approaches and an emerging comparative institutional approach to corporate governance that is grounded in organizational sociology. This new approach is aimed at a better understanding of the interdependence between governance mechanisms and the organizational and institutional environments in which these practices are conducted. This

³ Similarly, Williamson (1991: 277) suggests that mainstream corporate governance research is “too preoccupied with issues of allocative efficiency ... to the neglect of organizational efficiency in which discrete structural alternatives were brought under scrutiny.”

view implies that corporate governance practices do not have a direct and linear effect on performance. Rather, performance effects are contingent on a number of firm-level and macro institutional factors that are not accounted for in the vast majority of studies. In the following sections, we discuss these important contingency factors and their potential effects on the effectiveness and efficiency of specific governance mechanisms.

-- Table 1 about here --

As Table 1 indicates, comparative institutional approaches to corporate governance framework challenge a number of key assumptions of traditional agency theory approaches. Comparative institutional approaches broaden the research focus beyond the dominant manager-shareholder dichotomy to consider other important organizational stakeholders and the effects of institutional environments on the firm-level governance mechanisms. The organizational problem of corporate governance is no longer conceived as a universal agency conflict but recognizes the diverse nature of agency conflicts across institutional settings. Rather than applying a universal set of corporate governance remedies, it is recognized that institutions shape the effectiveness of different corporate governance solutions in complex ways through the availability of functional equivalents or via unintended consequences of governance measures in a particular context. Consequently, it moves away from a context-free hypotheses and implicit focus on the U.S. or UK institutional environment both empirically and as a normative benchmark. By contrast, comparative approaches aim at understanding how different formal and informal institutions can “contextualize” agency conflicts identified by previous studies. This departure from a universalistic conflict of interests between managers and shareholders and the recognition of potential differences between the extent and nature of agency conflicts in various institutional environments allow development of a more holistic approach to governance problems and their potential remedies that take into account possible moderating roles of national institutions. Finally, a

comparative approach has important implications for public policy agendas that have dominated political agendas in the post-Enron era. More specifically, it rejects a universalistic idea of effective regulation through law and codes addressed to abstract market actors in favor of a more socially embedded view of how regulatory meanings and practices are embedded in wider social networks, formal associations of stakeholders and professional communities of practice. National institutions thus mediate the impact of regulation in ways that highlight possibilities of functional equivalence or unintended consequences of such initiatives.

Corporate Governance and Legal Institutions

Institutional theory emphasizes that legal rules and norms form an important element of national institutional systems. A key example in recent years is the major stream of literature examining the role of legal origins (La Porta et al, 2000). This research shows how different legal traditions (e.g., common versus civil law) are linked to the levels of investor protection, which, in turn, shape agency relationships by influencing the power of shareholders vis-à-vis the board, as well as the relative influence of minority versus large shareholders. However, understanding legal institutions in terms of the dichotomous categories of common law versus civil law systems has been widely critiqued as too simplistic on both theoretical and empirical grounds (Coffee, 2001; Armour, Deakin, Sarkar, Siems & Singh, 2009).

Institutional theorists extend this research by examining how the influence of the law on corporate governance is itself embedded within a wider institutional environment of a country, in particular its regulatory framework. For example, in addition to various ‘hard laws’, the influence of voluntary codes and various forms of ‘soft law’ are gaining significance, such as the OECD Principles of Corporate Governance, the UK Corporate Governance Code, or self-regulatory initiatives for corporate social responsibility (Aguilera & Cuervo-Cazura, 2004; Brammer, Jackson & Matten, 2012). Likewise, large variation exists in

the degree to which law on the books is effectively enforced by the courts or other state agencies across countries. As Zhou & Peng (2010: 360) argue, “Cross-country differences in the legal origin, exchange scope, government capability, and political power distributions lead to the heterogeneity of countries’ legal developments”. Building on the existing research, this section focuses on how various national laws define the relationship between a company, its directors and shareholders and how this affects the nature and extent of potential conflicts of interest and the effectiveness of governance solutions.

Mainstream corporate governance research begins from a universal notion of shareholders as principals and managers as agents of the shareholders. Most legal remedies to the agency problem lie within either strengthening the accountability of the board (for example, increasing board independence through more independent (non-executive) directors on board), or promoting greater shareholder engagement by providing rights for shareholders to exercise control by challenging managerial decisions in the context of the Annual General Meetings of shareholders (AGMs) or through the courts. However, a closer look at different legal systems shows that the agency relationship itself is constituted in law, but on the basis of very different approaches to defining the rights and responsibilities of shareholders and directors.

Profound differences remain in the rights and responsibilities of shareholders as principals. For example, Japanese company law confers wider decision making powers to the shareholders meeting relative to the US state corporate laws. Dividend payments, the repurchase of shares and directors’ remuneration all require shareholders’ approval at the annual general meeting in Japan. Furthermore, shareholders can propose amendments of article of incorporation without proposal by the board of directors, while it is impossible in the United States (Shishido, 2007). Nonetheless, a majority of Japanese shareholders have historically been long-term strategic investors, including other non-financial corporations,

rather than institutional investors, and do not use their potential influence to promote the financial interests in line with fiduciary duties to principals (Aoki, Jackson & Miyajima 2007).

Similarly, national corporate laws confer authority on directors and interpret their role as the ‘legal agents’ of the shareholders in very different ways (Davies, 2008). For example, in contrast to the corporate governance debate prevalent in economics and finance research, corporate law in many jurisdictions regulates the actions of the board of directors as a collective entity and defines their duties in relation to the company itself, rather than the shareholders. This is not surprising as allowing the recognition of directors’ duties owed to shareholders individually would undermine ‘the collective nature of the shareholders’ association in a company’, and the fundamental rule that ‘the duties are owed to and are enforceable by the company’ (Davies, 2008: 480). The interests of the company, in turn, go beyond the immediate financial interests of shareholders and reflect a more subtle idea of shareholders’ interests being interdependent with a wider set of stakeholders’ objectives (Parkinson, 2003). Specifically, the UK company law defines the company as a private association of shareholders, but also applies a notion of ‘enlightened’ shareholder value that reflects a broader public interest in as much as the company must consider the wider interests of stakeholders (Keay, 2011). By contrast, German corporate law takes a more explicitly constitutional view of the corporation as an entity separate from any particular group, and requires different stakeholder groups such as employees to be explicitly represented on the board (Donnelly et al., 2000).

In the US, no federal corporation law exists, and each state specifies the basic elements of the corporation in its corporation statutes. Most state corporation laws recognize that management power lies in the board of directors, who owe broad obligations to act in the corporation’s best interests (Solomon & Palmiter, 1994; Keay, 2011). This approach is also

found in both common law jurisdictions of Southern and East Asia, and in jurisdictions inheriting “civil law” traditions, such as Japan (Nakajima, 1999). However, the 2002 legal reform allowed Japanese companies to choose between different structures of the board of directors, and lead to vast differences in the extent the board is made up of corporate insiders or also represent independent outside directors along the Anglo-American model (Nakajima, 2007).

By looking beyond a universal “manager-shareholder” dichotomy, these examples show that the basic principal-agent problem is always embedded within legal institutions that construct and legitimate the relationship between shareholders, the board, and the wider interests of the company in different ways. For example, Deakin & Singh (2008) show that differences in legal environments shape agency conflicts depending on how legal institutions treat duties company directors owe to their company.

A key implication is that legal systems may, in turn, strongly influence the effectiveness of different internal and external corporate governance mechanisms, including the market for corporate control. Again, agency theory suggests a universal set of remedies that can mitigate agency conflicts within the firm, such as independent boards, shareholder engagement with managers, etc. However, the effectiveness of these governance measures depends crucially on how governance remedies are translated into legal options available to various groups of stakeholders. Likewise, legal institutions vary across countries with regard to how the framework of rules strikes a balance between constraining the potential abuse by managers of their powers, while avoiding undermining the efficiency gains from having a strong centralised management (Davies, 2008).

A clear example of diverse legal institutions concerns the market for corporate control. Whereas UK corporate law reserves shareholders the fundamental right of decision and thus binds directors to neutrality in the face of a takeover bid, US law allows for a more active role

of the board toward unsolicited bids and allows a greater scope of potential defensive actions (see Jackson, 2010). Meanwhile, Japan has largely followed US legal norms in allowing board discretion in response to takeover bids, but has gone a step further in elaborating a legal norm of the abuse of the rights of a bidder and enterprise value in ways that take account of wider stakeholder relationships (Whittaker & Deakin, 2009). Even these ‘similar’ legal norms have shaped the effectiveness of takeover markets in different ways that vary according to the wider institutional context—US firms facing an active but highly contested market with high share price premiums, whereas Japanese firms face a less active market but one more effectively focused on poorly performing companies (Jackson & Miyajima, 2008).

The delicate balance between managerial autonomy and shareholder rights is struck by focusing primarily on providing remedies for breaches of directors’ duties in regard to illegality, fraud, gross negligence and conflicts of interest. Nevertheless, in line with the different conceptions of directors’ duties to the company, significant differences exist in how directors’ duties are enforced as corporate governance solutions even within both civil and common law jurisdictions respectively. For example, although the overhaul of the UK company law in 2006 introduced a procedure for derivative claim, to safeguard against unwarranted shareholder activism, it requires a shareholder to obtain the court’s consent to proceed with the claim. By contrast, in many US states, shareholders are more successful in taking derivative actions against managers (Hertig, 2004).

Some scholars have explained the lack of litigation outside the US by focusing on cultural and societal reasons (Kawashima, 1963; 1979). Others have identified institutional barriers, such as ineffective law enforcement institutions combined with high costs, insufficient availability of courts, judges and lawyers, which often deter people from considering litigation as a realistic governance enforcement option (Haley, 1978), especially in Asia and South-East Asia. As an example, Japan introduced a fixed rate for the filing fee of

shareholder derivative actions regardless of the damages sought and allowed the award to the successful shareholder plaintiffs damages for time and money spent on bringing the suit, in addition to the recovery of legal fees afforded prior to the revision (West, 2001). In order to reduce the risk of derivative suits, Japanese companies created the post of “*shikkō yakuin*” (executive officers), who had decision making powers but without being members of the board, and cut down the size of the boards.

The effectiveness of using courts as an enforcement mechanism in corporate governance depends to a large measure on the extent to which the legal system in a particular country is prepared to consider cases of failed business decisions, misguided strategy and other managerial mistakes (see, for example, Ramseyer & Nakazato, 1999, on Japan; Baum, 1996, on Germany; Law Commission 1999 and Nakajima, 1999, on English and other common law jurisdictions in Southern and East Asia; and Palmiter, 2006, on the US). Generally speaking, with the exception of fraud, illegality, gross negligence or conflicts of interest, shareholders have difficulties with taking directors to court for breaching their duty of care owed to the company (Hertig, 2004). What agency theory takes for granted in terms of shareholder rights may be difficult to exercise in practice.

In sum, this discussion clearly shows that it is important to recognize that national legal systems have a very strong impact on how the rights of principals and the duties of directors are defined and executed, as well as how potential conflicts and breaches of directors’ responsibilities are dealt with. What traditional agency-grounded research has considered as a universal set of conflicts between managers (agents) and shareholders (principals) may have a wide range of interpretations within different legal regimes. More importantly, the effectiveness of governance mechanisms, such as shareholder engagement and proactive involvement of independent board members is also underpinned by legal frameworks in different countries, including corporate laws. This integration of legal and

economics perspectives represents a significant departure for non-contextualized, traditional agency framework since it shows that the firm's governance is strongly embedded within the fabrics of national laws, and this argument extends to a variety of corporate governance practices which so far have been considered as universal principles of "good governance".

The Governance Roles of Dominant Shareholders and Investor Protection

Most corporate governance research is focused on corporations with diffused ownership, as commonly found in the US or UK. Recent literature has sought to extend agency theory to understand contexts dominated by concentrated ownership (see discussion in Filatotchev, Zhang & Piesse, 2011). Blockholding is an important but diverse phenomenon in Asia, which includes families (e.g. Taiwan), state agencies (e.g. China), banks (e.g. Japan) or complex inter-corporate groups involving all of these elements (e.g. Korean chaebols). Agency theory ascribes a somewhat ambivalent role to concentrated ownership, since concentrated ownership may reduce agency costs related to the separation of ownership and control, but also lead to new conflicts arising between majority and minority shareholders (see Hansmann, 1996; Shleifer & Vishny, 1997). Here a potential trade-off exists between the monitoring incentives and entrenchment through rent-seeking effects associated with concentrated shareholding.

This trade-off is well established in the literature, and prior studies associate an effective balance between the two types of behavior with the firm's idiosyncratic characteristics such as a phase in the life-cycle, patterns of innovation, etc. In terms of monitoring, greater concentration of cash-flow rights in the hands of large-block shareholders leads to greater incentives to monitor and alignment with the interests of minority shareholders (La Porta et al., 2000). In terms of rent-seeking, large-block shareholders may abuse their power and try to extract a control premium at the expense of other shareholders, and this opportunistic behavior would deter outside investment and negatively affect the

firm's value. A fast growing literature now concerns these so-called 'private benefits of control' (e.g., Grossman & Hart, 1988; Harris & Raviv, 1988). This issue is particularly important in countries with relatively low legal protection of minority investors and thus opportunity for extensive expropriation of minority shareholders by the controlling shareholders. This expropriation may take various forms, such as related-party transactions, use of transfer pricing, assets stripping and other forms of 'tunneling' of revenue and assets from firms (see Morck, Shleifer & Vishny, 1998, and La Porta et al., 2000). As a result, the primary agency problem in this institutional context is not the failure of professional managers to satisfy the objectives of diffused shareholders, but rather the expropriation of minority shareholders by the controlling shareholders (La Porta et al., 2000; Shleifer & Vishny, 1997).

A comparative institutional approach to corporate governance suggests going one step further in understanding the effectiveness of blockholding as something that depends on additional institutional variables. In particular, the incentive/entrenchment trade-off associated with concentrated share ownership depends on both legal institutions regulating minority shareholders and the wider sets of social norms shaping the identities and behavior of large owners. The importance of institutions can be illustrated within the substantial body of research focused on family ownership, especially in the environment of emerging and less developed economies (Claessens et al., 2000). These firms constitute a large proportion of listed companies in a number of countries in East Asia and India (Bruton, Ahlstrom, & Wan, 2003; Peng & Zhou, 2005). Here corporate control is largely dependent on a pyramid ownership structure with equity cross-holding amongst associated firms. While family-owned business has been the subject of numerous studies (see Filatotchev, Strange, Piesse & Lien, 2007; Young et al., 2008, for a review), the results on the effectiveness of family ownership in corporate governance are largely inconclusive.

Some evidence suggests that family owners may have superior monitoring abilities compared to diffused shareholders, especially when this is combined with family control over management and the boards of firms (Anderson & Reeb, 2004). Since owners in the current generation have the tendency and obligation to preserve wealth for the next, family firms often possess longer time horizons compared to non-family firms (Bruton et al., 2003; Dhandirek & Tang, 2003). Heugens, Essen & Oosterhout (2009) also find a positive relationship between concentrated ownership and firm financial performance in their meta-analysis of studies in Asia. Thus, family firms represent a special class of large shareholders that may have a unique incentive structure, a strong voice in the firm, and provide powerful checks and controls over managerial opportunism.

Other evidence suggests that family owners may create conflicts between dominant and minority shareholders, which they call a “principal-principal” form of agency conflict (Young et al., 2008). Governance problems associated with family control are typically related to the increased likelihood of the abuse of power (Jiang & Peng, 2011). Research from North America (e.g. Morck et al., 1988, Smith & Amoako-Adu, 1999), India (Vissa, Greve & Chen, 2010) and South-East Asia (e.g., Filatotchev et al., 2005; 2007) provides evidence of the negative effect of a controlling family on corporate performance. Here family interests may dominate over the interests of non-family shareholders, since the concentration of personal and family wealth in family-controlled firms normally creates a preference for wealth distribution towards dominant owners over other dimensions of firm performance, such as maximization of dividend payments to outside shareholders (Carney & Gedajlovic, 2002). Similarly, a high overlap between the controlling family and management in certain settings may also lead to weak monitoring and render the opportunity for shareholder expropriation commonplace (Filatotchev et al., 2005). Finally, family control tends to shield a firm from the disciplinary pressure of the market for corporate control since concentrated

share ownership reduces the probability of a hostile take-over (Gomez-Mejia, Larraza-Kintana & Makri, 2003). While such protection may enhance investments in firm-specific capital by stakeholders, it may also contribute to managerial entrenchment and ineffective patterns of organization – thus making the performance effects ambiguous.

The comparative institutional perspective summarized in Table 1 helps to resolve these contradictory arguments by suggesting that whether or not concentrated ownership promotes effective corporate governance may depend on the presence or absence of various types of national institutions. For example, Zhou & Peng (2010) theorize that whether the impact of family ownership and control on firm value is good, bad or irrelevant depends on the level of shareholder protection embodied in the legal and regulatory institutions and these vary across countries. They suggest that in countries with less developed institutions more control through a family CEO or pyramid structure may afford controlling families more opportunities to expropriate funds from minority shareholders (see also Young et al., 2008). In addition, institutional environments characterized by informal networks based on trust, reputation considerations may be a powerful factor that restrains family owners' opportunism (Filatotchev et al., 2011).

Again, these arguments show that the diversity of formal and informal institutions across countries may significantly shape the nature and extent of agency conflicts on a firm level. In countries where minority shareholders' interests are not adequately protected by national law, regulation and reputational considerations, agency problems on a firm level may shift from the conventional manager-shareholder conflict to potential goal incongruence among shareholders themselves. At the same time, far from being a solution to principal-agent conflicts, ownership concentration may lead to a new type of agency problems described as a principal-principal conflict (Young et al., 2008).

Executive Compensation Debates and Informal Institutions

Executive compensation has become one of the most hotly debated topics within corporate governance research. As Bruce et al (2005: 1493) indicate, “In recent years, literature on executive remuneration has grown at a pace rivaled only by the growth of executive pay itself.” Most agency theoretical research assumes that pay systems aligning the incentives of managers with those of shareholders will help firms operate more efficiently and perform better. As Jensen & Murphy (1990: 242-243) observe, “Agency theory predicts that compensation policy will tie the agent’s expected utility to the principal’s objective. The objective of shareholders is to maximize wealth; therefore agency theory predicts that CEO compensation policies will depend on changes in shareholder wealth”. The key metric associated with positive organizational outcomes is pay-performance sensitivity (Bruce et al., 2005). In response, companies around the world have increasingly moved from a fixed pay structure to remuneration schemes that are related to performance and include a substantial component of equity-based incentives.

A large empirical literature in the US and UK has examined the organizational outcomes of different executive pay components, such as cash pay (salary and bonus), long-term incentives (e.g. executive stock options) and perquisites (pension contributions, company cars, etc). Although executive incentives are increasingly considered as an important, “non-coercive” element of corporate governance, the structure, size and effectiveness of executive compensation schemes in different countries remain very diverse. Table 2 illustrates this diversity through a breakdown of CEO compensation packages in the largest companies around the world. For example, in the U.S., incentive plans account for a lion share (60 percent) of the total compensation, whereas base salary and cash bonuses provide only 23 and 17 percent of the total respectively. In Japan, 71 percent of the total executive compensation is related to base salary, with executive equity plans accounting only

for 17 percent. European countries are somewhere in between, with executive remuneration more evenly distributed among the three components.

-- Table 2 about here --

Marked differences also exist in terms of the total value of executive compensation. For example, Thomas (2009) reports results of a CEO pay survey around the world by Tower Perrin and shows that total CEO pay in Germany, Sweden and China amounted to 51, 44 and 21 percent of CEO pay in comparable firms in the U.S.

This diversity in the structure and levels of executive compensation reflects the distinct institutional contexts in which these pay packages are conceived, implemented and monitored—factors often ignored in agency theory. Executive pay packages are not only governed by economic efficiency or the reduction of agency costs, but must be socially legitimate within specific and sometimes contested social contexts. Institutional theory suggests that executive pay systems are socially embedded practices shaped by regulatory institutions, but also subjected to social norms of professional groups and diffuse through processes of imitation and emulation of taken-for-granted social forms.

In the U.S., stock-based executive compensation is so prevalent to have achieved “taken for granted status” (Sanders & Boivie, 2004: 171). From an agency perspective, U.S. investors would appear to place great reliance on this measure as the preferred incentive alignment mechanism. Still, much debate remains about whether these pay packages are, in fact, sensitive to performance at all (see Bebchuk & Fried, 2004; Kaplan, 2008; Wyld & Maurin, 2008). Understanding their prevalence in the US requires looking at wider sets of institutions such as their favorable tax treatment under U.S. accounting rules, as well as the non-egalitarian social ethos of the U.S. and normative assumptions about managers being motivated by self-interest and extrinsic rewards. These pay packages are likely to be ineffective in reducing agency costs if supporting complementary institutions are absent or

weak, such as independent directors and shareholder “say on pay.” For example, high pay levels and equity-based incentives are associated with high levels of institutional investors’ ownership and absence of strong and “patient” blockholders (Fernandes et al., 2010). Institutional investors often fail as effective monitors and adopt more pro-management stances if they are dependent on other sorts of business from corporations, such as managing corporate pension funds (Davis & Kim, 2007). Meanwhile, the institutionalization of stock options may have other unintended effects. For example, the size of stock options has a very strong influence on the prevalence of earnings restatements (Efendi, Srivastava, & Swanson, 2004; Denis, Hanouna & Sarin, 2006).

Another regulatory institution shaping executive pay has been the role of disclosure and transparency (Conyon & Murphy, 2000). For example, a universal requirement to disclose the structure and level of executive compensation in the U.S. was hoped to slow the increase in executive pay, with the publicity about high pay working against abuses. However, Hall (2003: 32) argues that “once executives began to see more clearly how much their peers were making, they wanted more – and boards granted more”. Thus, whilst disclosure was generally aimed at curbing excesses, it also had unintended consequences by creating a fertile ground for abuses. For example, DiPrete, Eirich & Pittinsky (2010) have shown the network diffusion of CEO pay, where a small and shifting fraction of CEOs regularly “leapfrog” their compensation benchmarks (after controlling for performance). Thereby, governance failures in individual firms propagate through corporate networks via the benchmarking system used to raise executive salaries. These deviant events produce subsequent “legitimate” pay increases for others.

Outside the U.S., executive stock options often contradict prevailing institutionalized norms and coalitions of interest (Bruce et al., 2005; Buck & Sharhram, 2005). When investors rely on reputational considerations rather than formal equity-based incentives in evaluating

the probability of self-serving behavior of managers, the presence of executive share options would have relatively lower weight in terms of the firm's expected cost of capital (Bhagat, McDevitt & McDevitt, 2010). For example, in German and Japanese corporate governance systems, monitoring has been based on relationship-oriented banks rather than an active market for corporate control (Aoki, 2001). The long-term nature of bank-firm relationships may also complement a more active role for other stakeholders, such as employees, as employees' investments in firm-specific capital are protected from "breaches of trust" (Aoki, 2001). Here, the applicability of equity-based incentives is generally restricted compared to the U.S., as clearly indicated in Table 2. However, in cases where these institutions have weakened, stock options have also taken root in these countries, albeit in greatly modified form, such as smaller size options in Japan (Aoki et al., 2007) or more regulated holding periods for the exercise of options in Germany. Thus, stock options have been a largely symbolic adoption as a signal to foreign shareholders but remained largely decoupled from other organizational practices (Fiss & Zajac, 2004; Sanders & Tuschke, 2006).

The broader point is that institutional factors may have a significant impact on the roles of executive compensation schemes as well as their effectiveness in re-aligning interests of managers and shareholders. This extends our understanding of the governance roles of executive compensation beyond the confines of agency framework. Research in other Asian countries have also shown stakeholder influence on executive pay in South Korea (Kato, Kim, & Lee, 2005) or the importance of relationship and network influences in China (Firth, Fung, & Rui, 2006; Kato & Long, 2006), even despite newer elements of "stock market capitalism" after the Chinese economic reforms. Buck, Liu & Skovoroda (2008: 4) suggest that "Chinese institutions (including culture as an informal institution) may have inhibited the adoption of long-term incentives in the form of equity-based pay, and thus reduced the responsiveness of pay to share price performance."

In sum, institutional analysis extends traditional agency framework further by suggesting that the effectiveness of executive compensation is shaped by a complex set of institutional factors that tend to differ across countries. In economies characterized by dispersed share ownership, less significant roles of stakeholders and higher tolerance to income inequality, executive incentives are a legitimate instrument of corporate governance aimed at aligning interests of managers and shareholders (Hall, 2003), even where the effectiveness remains questionable. However, in societies with strong egalitarian tendencies, powerful stakeholders and reputational concerns that frame managerial behavior, the effectiveness of executive compensation must be seen in a different context. Again, these arguments suggest that national institutions represent important contingency factors that may influence the adoption and effectiveness of firm-level governance practices, contrary to the universalistic framework that until recently dominated agency-grounded research.

Comparative Institutional Analysis as an Emerging Research Agenda

This paper suggests scholars interested in corporate governance in Asia or in broader comparative perspective should make greater use of institutional theory. Unlike the stress on economic efficiency in universal principal-agent models, institutional theory offers a way of understanding how the effectiveness of corporate governance is contingent upon a number of organizational, social and political factors. In illustrating this approach, we have argued that the nature and extent of agency conflicts in the firm are shaped by the specific institutional environments within which the firm operates. Moreover, the effectiveness of corporate governance solutions to various conflicts of interest is far from being universal, as suggested by agency-inspired research in economics and finance. Effectiveness depends on the specific formal and informal institutions and how such institutions legitimate and empower different sets of stakeholder interests and compromises among the positions of different actors.

How should new research begin to further develop a more comparative and institutionally embedded governance framework to analyze organizational outcomes of various governance practices? Here we highlight a several key ideas. First, a comparative approach must go beyond a thin view of institutions as simply increasing or decreasing agency costs. Rather, a thicker understanding of institutions is needed to identify the salient dimensions along which institutions vary (see Aguilera & Jackson, 2003) and how these mediate the effectiveness of corporate governance practices. While many single country case studies have generated substantial insights into locally diverse institutions, a large gap remains in systematizing this knowledge and developing a more theoretically informed comparative understanding of institutions. For example, future studies may compare the governance role of executive compensation in different contexts of emerging economies, such as family controlled firms in India or state-controlled Chinese and Russian companies. Similarly, it is important to understand what factors underpin board effectiveness in various institutional contexts. For example, do independent directors perform significant governance roles in family controlled firms in South-East Asia and India or in state-controlled but publicly listed companies in Russia and China?

Second, comparison may help highlight and understand how governance practices interact and potentially complement each other as related ‘bundles’. For example, Rediker & Seth (1995) suggested that governance factors operate in concert and lead to complementarity effects in terms of performance. Aguilera et al. (2008) also focus on interactions between governance practices and how these interactions align governance to potentially diverse organizational environments. An important implication is that effectiveness does not result from a universal “one best way”, but suggests that particular practices will be effective only in certain combinations and specific institutional environments. This framework can be extended further by examining how institutional factors, external to the firm, may also

complement internal governance mechanisms. For example, if there is a reputational pressure on executives to perform their duties in the interests of shareholders, then the effectiveness of executive compensation as a governance factor may have lesser importance. Similarly, strong involvement of stakeholders may complement blockholding by limiting the autocratic power of dominant shareholders. In short, this framework helps explain why no “one best way” exists to achieve effective corporate governance. Rather, corporate governance arrangements may give comparative institutional advantages for different types of firms or economic activities (Hall & Soskice, 2001). As a result, recent literature has found more complex or surprising combinations of corporate governance variables, than implied by early works that focused on a singular effect of a particular mechanism (Aoki & Jackson, 2008). While mapping such combinations of internal governance and external institutions is beyond the scope of this paper, the effect of national institutions on corporate governance practices clearly goes beyond a simple and linear moderation of the effectiveness of a particular governance practice. Future research is needed to explore the complex interplay between firm-level and more macro-level institutional aspects of corporate governance.

Third, interdependence among institutions may also lead to substitution among functionally equivalent corporate governance mechanisms. A good example of this relates to takeover markets. In the US and the UK, external governance via the market for corporate control plays an important role in disciplining managers by exposing them to a threat of takeover. However, hostile takeovers are much less common elsewhere and lack institutional legitimacy in many countries (Schneper & Guillen, 2004). In these settings, external governance often takes place within complex and informal networks based on reputation and trust (Bachmann, 2001). Can these relationships serve as a substitute to an active market for corporate control, especially in institutional environments based on strong networks and reputational concerns, such as China? For example, Globberman et al. (2011) argue that in

Asia informal institutions are often more important than formal institutions. Research by Wong & Tjosvold (2010) focuses on the effects of informal links, or *guanxi*, between different organizations in China in the context of conflict management. Their results show the importance of the governance roles of informal social networks that link an organization with its external partners. More specifically, *guanxi* reduces confrontational approach to conflict that, in turn, reduces instances of managerial opportunism and results in partnership effectiveness. Similarly, recent research on Japan suggests that strong relationship-based networks may help to channel and mediate market activity in ways that complement the corporate governance role of takeovers (Jackson & Miyajima, 2008).

Previous studies that combine strategic management and institutional research indicate that corporate governance often has to compensate or cope with the situation of “institutional voids” in emerging economies. For example, in their analysis of India and Chile, Khanna & Palepu (1997; 2000) argue that business group networks serve as a response to institutional “voids” resulting from government corruption and poor enforcement of business laws. Family-owned business groups often have dubious governance structures associated with poor information disclosure and insiders’ abuse of private information even in relatively developed emerging stock-markets such as Hong Kong (Filatotchev, Zhang & Piesse, 2011). But institutional change may also be accompanied by a re-configuration of governance practices. Looking at BRIC economies, Estrin & Prevezer (2011) argue that in China and some states of India, 'substitutive' informal institutions substitute for and replace ineffective formal institutions, and they are critical in creating corporate governance leading to enhanced domestic and foreign investment. In contrast, Russia is characterized by 'competing' informal institutions whereby various informal mechanisms of corporate governance associated with corruption and clientelism undermine the functioning of reasonably well set-out formal institutions relating to shareholder rights and relations with investors.

Fourth, a related implication of institutional theory is associated with the international diffusion of corporate governance practices (Gullén, 2004). For example, policy prescriptions enshrined in codes of 'good' corporate governance around the world often rely on universal notions of 'best practice,' which need to be adapted to the local contexts of firms or 'translated' across diverse national institutional settings (Aguilera & Cuervo-Cazura, 2004; Aguilera & Jackson, 2003; Fiss & Zajac, 2004). For example, the U.K. regulators currently feel that codes need to be strengthened by greater legislative underpinnings to assure enforcement. However, the fact that the U.K. approach is arguably the less universalistic and more contextualized may also help to explain why other countries on the whole have tended more to follow the U.K. Codes approach (Aguilera & Cuervo-Cazura, 2004). What is less clear is whether these countries have institutional characteristics similar to the U.K. and complementary firm-level governance practices that support the effectiveness of these codes. For example, Chen, Li & Shapiro (2011) 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 in Asian emerging economies, since governance practices are mainly designed to resolve conflicts between shareholders and the management rather than conflicts between controlling and minority shareholders.

Finally, an integration of institutional theory and corporate governance studies requires new research methodologies. The main bulk of corporate governance literature uses published data from company accounts, or relies on surveys of companies or investors. Much of this research attempts to link the presence of particular corporate governance practices (e.g. board committees) with the economic performance of companies (e.g. share price performance or profitability). One extension to this approach would involve drawing on new innovations in social science, such as set theoretical methods and configurational approaches

to organization to examine how corporate governance factors combine and produce different outcomes in different institutional contexts (see Fiss, 2007). Another extension is the need to examine how regulatory and informal institutions impact the processes of corporate governance itself. Such process-oriented research would incorporate a more qualitative understanding of governance outcomes and take greater account of the actual behavior of key participants. An important correlate to more comparative and institutional views of corporate governance is the necessity to collect and triangulate data from a variety of sources – such as combining statistical studies based on surveys and published information with follow-up of semi-structured interviewing about processes and case studies that look at how these processes interact. While the search for comparative qualitative data about corporate governance poses many new research challenges, we submit that this future research agenda will lead to better answers to many research questions and help provide a more realistic and policy relevant understanding about what makes corporate governance effective.

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Table 1
Normative Principal-agent Perspective vs Institutional Corporate Governance Framework

	Principal-Agent Model	Institutional CG Framework
<i>Research focus</i>	• Managers • Shareholders	• Managers; • Shareholders; • Stakeholders; • Institutional environment
<i>Organizational context</i>	• Focus on universalistic conflict of interests between managers and shareholders	• Recognition of differences between the extent and nature of agency conflicts in various institutional environments
<i>Organizational solutions</i>	• A set of universal corporate governance remedies, including: - board monitoring - concentrated ownership; - executive incentives; - market for corporate control	• Recognition that national institutions may impact upon the effectiveness of corporate governance solutions; some of them may have unintended consequences
<i>Account for national institutions</i>	• Context-free approach • Focus on the U.S./U.K. environment	• “Contextualization” of agency conflicts • Focus on moderating effects of national institutions
<i>Policy implications</i>	• Convergence of institutional frameworks • Universal effectiveness • Law and codes shape markets	• Diversity of institutional frameworks • Functional equivalence, unintended consequences • Law and codes shape networks, associations and professional orientations

Table 2
Structure of CEO Remuneration Packages Around the World

Country	Base Salary (%)	Cash bonus (%)	Incentive Plan compensation (%)
USA	23	17	60
Brazil	27	41	32
Germany	39	47	14
UK	40	38	22
France	44	25	31
Ireland	44	43	13
Hong Kong	51	19	30
Netherlands	51	28	21
Belgium	52	26	22
Italy	52	29	19
Japan	71	12	17

Note: Companies with revenues between \$1-3 billion

Source: Filatotchev and Allcock (2010)