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Journal of Comparative Economics 32 (2004) 617–636

Journal of
COMPARATIVE
ECONOMICS

www.elsevier.com/locate/jce

Political control and performance in China's listed firms

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Received 18 March 2003; revised 8 August 2004

Chang, Eric C., and Wong, Sonia M.L.—Political control and performance in China's listed firms

The performance implications of the involvement of grassroots local party committees of the Chinese Communist Party (CCP) in the decision making of China's listed firms are investigated. First, we show that the decision-making power of local party committees relative to the power of the largest shareholders is associated positively with firm performance. This result suggests that party control restrains the largest shareholders from expropriation but that the existing level of party control is insufficient to control the largest shareholders. Second, we show that the decision-making power of local party committees relative to managers is associated negatively with firm performance. This result suggests that the political costs associated with party control over managers are more detrimental to firm performance than are agency problems and that the existing level of party control over managers is excessive. On balance, our results indicate that the existing level of party control is excessive and that reducing the decision-making power of local party committees would improve the performance of China's listed firms. *Journal of Comparative Economics* 32 (4) (2004) 617–636. Faculty of Business and Economics, The University of Hong Kong, Pokfulam Road, Hong Kong; Hong Kong Institute of Economics and Business Strategy, Faculty of Business and Economics, The University of Hong Kong, Pokfulam Road, Hong Kong.

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JEL classification: P26; P31; G38

Keywords: Political control; Agency problems; Corporate governance; China's listed firms; Transitional economies

1. Introduction

Unlike reforms in other transitional economies, China's economic reform has proceeded without political reform. Economic reform was undertaken under the central leadership of the Chinese Communist Party (CCP). As a result, grassroots organizations of the CCP, hereafter referred to as local party committees, still exert an influence on most of China's firms. Not only have local party committees maintained their position in state-owned enterprises (SOEs) and reformed SOEs but they have also established themselves in newly formed private firms and foreign joint ventures. The theoretical literature discusses the effects of the involvement of local party committees on the performance of China's firms. First, the grabbing hand theory suggests that local party committees use firms to serve political and social objectives, which has a negative impact on the firm's economic performance (Qian, 1995, 1996; McGregor, 2001). Second, the helping hand theory argues that local party committees generate a positive effect on firm performance because they help secure scarce resources in the quasi-market economy and mitigate agency problems in firms with poor corporate governance (Qian, 1995, 1996; McGregor, 2001). Third, the ineffective hand theory considers local party committees to be only window dressing so that they have no impact on firm performance (McGregor, 2001). Hence, an empirical analysis of the effects of the involvement of local party committees in firms' decision making in China is important for understanding the political economy of China's reform and for the comparative study of reform strategies.

In this paper, we investigate the performance implications of the involvement of local party committees in the decision making of China's listed firms. We follow the literature that examines trade-offs between political costs and agency costs associated with political control of decision making in China's firms. Qian (1995, 1996), Li (2000) and Xu et al. (2002) suggest that political control of firms' decision making in China is associated with two opposing effects. On the one hand, political control increases costs because politicians use firms to serve political and social objectives. On the other hand, political control may prevent managers from serving their own personal objectives at the expense of firm performance. Therefore, the net effect of political control depends on the balance between political costs and agency costs.

Unlike previous studies that do not distinguish between political control exerted by local party committees and political control exerted by other sources, including local governments, line ministries, and state shareholders, we focus on control exerted specifically by local party committees, hereafter referred to as party control. Hence, we derive more explicit policy implications regarding the roles of local party committees in China's firms. Moreover, we distinguish between party control over shareholders and party control over managers. Many corporate governance studies suggest that shareholders and managers are distinct economic actors who are plagued by different incentive problems (Shleifer

and Vishny, 1997). Agency theory argues that managers pursue discretionary activities that benefit themselves at the expense of profit-maximizing shareholders (Williamson, 1963a, 1963b; Jensen and Meckling, 1976). However, recent studies on corporate governance suggest that controlling shareholders themselves may not maximize profits if their control rights allow them to expropriate minority shareholders and outside creditors (Shleifer and Vishny, 1997; La Porta et al., 2000). Nonetheless, since the incentive problems of managers and shareholders arise from different sources and operate through different mechanisms, we examine the performance implications of party control over these two actors separately. To clarify this distinction, the incentive problems of managers are called agency problems, and the incentive problems of shareholders are called expropriation problems.

The distinction between control over shareholders and managers is crucial to the analysis of political control in China's listed firms because most of the largest shareholders in the firms are state entities, including state asset management agencies and firms owned wholly by the government. These state entities share some, if not all, of the political objectives of local party committees; thus, party control over these shareholders does not result in much additional political cost. Compared with state shareholders, managers share fewer of the political objectives of the local party committees; thus, party control over managers is associated with higher political costs than is party control over the largest shareholders. Because of the difference in political costs, party control over the largest shareholders and over managers is expected to have different performance implications from control. We use a unique survey, hereafter referred to as SSES, conducted by the Shanghai Stock Exchange and Integrity Management Consulting Firm to extract evidence on the performance implications of these two types of party controls.¹

In addition to addressing issues relevant to firms in China, our study contributes to the growing literature on the depoliticization of firms' decision making in transitional economies. Most existing studies focus on the objectives of politicians and neglect the incentive problems of shareholders and managers (Frydman et al., 1996; Blanchard and Aghion, 1996; Earle et al., 1996; Hellman and Schankerman, 2000). As a result, policy prescriptions emphasize the reduction of political control over firms' decision making. Consistent with the findings of Qian (1995, 1996), Li (2000), and Xu et al. (2002), our results demonstrate the existence of an optimal degree of political control over firms' decision making in transitional economies due to poor corporate governance and weak legal protection for investors. Furthermore, we show that any given level of political control in a firm may be too high for some parties, e.g., managers, and too low for others, e.g., the largest shareholders, because of different balances between political costs and incentive problems. The paper is organized as follows. Section 2 reviews the literature and develops the hypotheses. The data and methodology used to test the performance implications of party control over firms' decision making are explained in Section 3. Section 4 reports the results. Section 5 concludes with policy implications and a description of the study's limitations.

¹ The survey is part of a three-year project conducted by the Shanghai Stock Exchange; the results of the project are reported and published by the Shanghai Stock Exchange (2000). This survey has also been used by Tenev and Zhang (2002), Opper et al. (2002) and Wong et al. (2004).

2. The literature and hypotheses

The notion that political control over firms' decision making is detrimental to firm performance is widespread in the literature on corporate governance and public choice. Most theoretical arguments rely on the assumption that politicians use firms to pursue political and social objectives, e.g., to correct market failures, to reduce income and regional inequality, and to provide excessive employment, and that these are detrimental to the firm's economic performance (Boycko et al., 1996; Shleifer and Vishny, 1994, 1998). The implicit assumption in this literature is that, in the absence of political control, shareholders and managers have an incentive to maximize profits. Nevertheless, the literature on corporate governance and finance suggests that managers and shareholders have objectives other than profit. Whereas agency theory considers the possibility that managers maximize sales, staff expenses, managerial emoluments, and funds available for discretionary use (Williamson, 1963a, 1963b; Jensen and Meckling, 1976), the corporate governance literature argues that controlling shareholders may steal profits, sell outputs at below-market prices, and divert investment opportunities to other firms that are also owned by the controlling shareholders. All these activities detract from the firm's performance (La Porta et al., 2000).

Given agency and expropriation issues, political control of the firm's decision making may improve firm performance by mitigating incentive problems. Even though they have non-profit-maximizing objectives, politicians have an incentive to prevent controlling shareholders and managers from engaging in behavior that reduces the amount of resources over which politicians have discretion (Brada, 1996). In this circumstance, the net effect of political control depends on the balance between political costs and incentive problems of managers and shareholders.

In their analysis of political control over firms' decision making in SOEs, Boycko et al. (1996) argue that political costs are more detrimental than agency problems to firm performance. However, they provide no systematic evidence to support this hypothesis. Based on detailed examinations of the corporate governance of SOEs in China, Qian (1995, 1996) concludes that political control over firms' decision making mitigates agency costs because of the checks and balances instituted by the politicians. Based on this insight, Li (2000) determines the optimal degree of political control given the existence of both political and agency costs. By employing several proxy variables to capture political control in China's SOEs, this author provides evidence that tighter political control results in more unprofitable production and more surplus employment, both of which distort production decisions. However, tighter government control also forces managers to cut wages and bonuses when enterprise performance is poor, which reduces agency costs. Finally, Xu et al. (2002) examine the trade-off between political costs and agency costs in China's shareholding firms. By separating firm autonomy into two categories, namely, autonomy in labor decisions and autonomy in all other decisions, these authors provide evidence that firm performance is affected positively by autonomy in labor decisions but negatively by autonomy in all other decisions. They suggest that labor decisions are dominated by political costs and that other decisions are dominated by agency costs.

Our sample consists of firms listed on the Shanghai Stock Exchange; they are mainly SOEs that have been converted into shareholding firms according to China's Company

Law. These firms are considered role models for China's modern firm system and meant to be subject to less political control than traditional SOEs. However, the corporate governance structure of listed firms still includes three major sources of political control. One of these was created as a result of state shareholding. By 1999, 42 percent of the largest shareholders in China's listed firms were holders of state shares and 57 percent were holders of legal-person shares.² At the end of 1999, SSES revealed that more than 90 percent of the largest shareholders holding legal-person shares were SOEs rather than private investors. In other words, nearly all the largest shareholders were state entities. Hence, state shareholding enables the government to remain involved in, and even dominate, firms' decision making. The second source of control lies in the government and ministries that have maintained a certain degree of authority over China's listed firms. Although China's central leadership has accelerated the process of making enterprises independent from the government since the promulgation that China is a socialist market economy in 1994, numerous case studies demonstrate that government administration and line ministries have not cut ties with firms completely (World Bank, 1997). According to SSES, about 56 percent of the listed firms still maintain formal ties with local governments and ministries, with the latter acting as the firms' administrative superiors. The third source of control comes from local party committees. In China, managers' decision making has been subject to the control of local party committees since the early 1950s (You, 1998).³ The promulgation of the Company Law in 1993 did not eliminate the influence over firms' decision making by local party committees, which are still allowed to maintain their supervisory and monitoring role in shareholding firms.⁴ According to SSES, local party committees in the listed firms have remained involved in all major corporate decisions, particularly personnel decisions (Shanghai Stock Exchange, 2000; Tenev and Zhang, 2002; McGregor, 2001).

We expect that party control over the largest shareholders is associated positively with firm performance because it mitigates the shareholder's expropriation problems without adding significantly high political costs. To justify this expectation, we note that shareholding in China's listed firms is highly concentrated. At the end of 2001, the average

² There are four main types of shares in China's listed firms, namely state shares, legal-person shares, A-shares, and B-shares. State shares are held primarily by state asset management agencies or SOEs. Legal-person shares are held by domestic institutions or firms. Whereas A-shares are held mainly by domestic individual investors, B-shares are held exclusively by foreign investors and are traded against foreign currency. However, national individual investors have also been allowed to invest in B-shares since February 2001. In addition, foreign investors have been allowed to invest in the A-share market through the qualified foreign institutional investors scheme since December 2, 2002.

³ The relationship between local party committees and firm managers or directors in China is commonly characterized as a relationship between two centers. The relative distribution of decision-making power between these two centers determines how much political control and economic force is applied at the firm level. Because of its far-reaching political and economic implications, this issue has been the focus of a policy debate since the founding of the People's Republic of China (You, 1998 and Opper et al., 2002).

⁴ Concerning party activities, Article 17 of the law states that the activities of the local party committees of the CCP in a firm shall be carried out in accordance with the constitution of the CCP. Article 31 of the constitution of the CCP assigns the implementation function of higher party decisions to local party committees within firms, while Section 7 assigns the right to supervise party cadres and any other personnel explicitly to local party committees. In effect, this provision gives local party committees a supervisory and monitoring role in shareholding firms.

shareholding of the largest shareholders stood at 44.94 percent, the second largest at 8.56 percent, and the third largest at 3.27 percent. About 42.53 percent of the largest shareholders held more than 50 percent of shares. As a result, controlling shareholders can dominate the firm's decisions and expropriate other investors (Tenev and Zhang, 2002; Tam, 2002; Shanghai Stock Exchange, 2000). The fact that most listed firms in China are spin-offs from large SOEs with parent groups serving as their largest shareholders compounds expropriation problems between controlling shareholders and minority investors. Tenev and Zhang (2002) argue that the boundaries between listed firms and parent groups are relatively new and often artificial so that listed firms are assumed to help a parent company when the need arises. Hence, many controlling shareholders treat listed firms as cash cows from which they can benefit themselves at the expense of other investors. Documented abuses by controlling shareholders include obtaining soft loans from listed firms, using listed firms as guarantors to borrow money from banks, and buying and selling goods, services, and assets at unfair prices (Tenev and Zhang, 2002; Tam, 2002; World Bank, 1997).

Managers in China's listed firms are also plagued by agency problems (Shanghai Stock Exchange, 2000; Tenev and Zhang, 2002; Tam, 1999, 2002; Qian, 1995, 1996). According to SSES, the main source of managerial compensation is salary. Because managers aspire to a civil service rank, salaries for different categories of managers are low and undifferentiated. Furthermore, stock-based incentives are weak because the average shareholding of managers in the listed firms was only 0.006 at the end of 1999.⁵ In addition, no external market for corporate control exists in China. As a result, most of China's listed firms lack compensation schemes and external pressure that tie the manager's incentives to firm performance. On the other hand, salary, bonuses, and shares are not the only way to reward managers. In a rent-seeking society, on-the-job perks, such as better housing, the use of cars, entertainment, restaurant meals, travel, diversion of assets, and business opportunities, can be substantial (Qian, 1995, 1996). To capture these benefits, managers must keep their jobs. Surprisingly, little systematic evidence is available on whether managers in China would lose their jobs if their firms performed poorly.

Tam (1999, 2002) and Tenev and Zhang (2002) suggest that managers are unlikely to be removed on the basis of poor firm performance because of the involvement of state and party bureaucrats in the appraisal process. However, Groves et al. (1995) offer systematic evidence that managers of China's SOEs were fired for poor firm performance. To investigate this issue, we collected data on managerial turnover in China's listed firms from 1998 through 2001 and examined the way in which managerial turnover is related to firm performance. Table 1 reports the incidence of non-routine managerial turnover for all listed firms and also for firms in which performance declined. We define managerial turnover as non-routine if a manager is replaced for reasons other than sickness, death, or being above the normal retirement age of 65. We exclude cases in which the manager previously served as both the Chair of the board of directors (BoD) and manager and continued to serve as the Chair after being replaced as manager. In addition, a listed firm is said to experience

⁵ Managers in China's listed firms are forbidden to accumulate more than 0.5 percent of the firm's total shares or to sell their shares until six months after they have left their firms.

Table 1
Managerial turnover in China's listed firms

	1998	1999	2000	2001
All				
No. of firms	819	916	1052	1122
No. of non-routine turnover	254	269	258	265
Non-routine turnover (%)	31.0	29.4	24.5	23.6
P50P50N25				
No. of firms with performance decline	10	18	19	27
No. of non-routine turnover	4	7	7	10
Non-routine turnover (%)	40.0	38.9	36.8	37.0
P50P50N10				
No. of firms with performance decline	4	4	4	6
No. of non-routine turnover	3	2	3	4
Non-routine turnover (%)	75.0	50.0	75.0	66.7

Notes. (1) The category denoted P50P50N25 refers to firms in which the ratios of pre-tax operating income to tax exceeded the industry median for the previous two consecutive years but then dropped to below the bottom 25 percent of the industry. (2) The category denoted P50P50N10 refers to firms in which ratios of pre-tax operating income to tax exceeded the industry median for the previous two consecutive years but then dropped to below the bottom 10 percent of the industry.

a decline in performance if its ratio of pre-tax operating income to asset has been above the industry median for the previous two consecutive years but drops to below either the bottom 25 or 10 percentile in the industry.

From the data in Table 1, the average percentage of non-routine managerial turnover, without considering firm performance, for all of China's listed firms was about 27 percent from 1995–2001. However, in each year, the incidence of non-routine turnover was markedly higher for firms in which performance declined significantly. In 2000, about 37 percent and 75 percent of the managers of firms in which performance dropped to below the bottom 25th and the 10th percentiles, respectively, were dismissed, compared to a dismal rate of about 24.5 percent overall.⁶ Our finding is consistent with Groves et al. (1995) that managers in China are held accountable for poor performance; therefore, we conclude that managers must achieve an acceptable level of performance to maintain their on-the-job perks. If the incentives of managers are better aligned with firm performance than are those of politician as claimed by Boycko et al. (1996), and managers whose firms perform poorly are fired, the political costs associated with party control over managers should be greater than agency costs. Hence, we hypothesize that political control over managers is associated negatively with firm performance.

⁶ We obtained data on managerial turnover from the Shanghai Wind Information Co., Ltd. (WIND), which is a private firm that has specialized in providing data on China's securities market since 1992. The information on reasons for managerial changes and on the age of managers is from the Taiwan Economic Journal Mainland China Database.

3. Data and empirical methods

Direct empirical investigation of the relationship between political influence on firm decision making and firm performance is difficult because of the need to identify objective measures of the extent of political influence on a firm's decision making. Two approaches are taken to construct such measures. Earle et al. (1996), Li (2000) and Xu et al. (2002) use proxy variables, e.g., the sale of products to government customers, the level of subsidies received from the government, and the level of excessive employment. Hellman and Schankerman (2000) and Wong et al. (2004) use surveys to assess the extent to which politicians are involved in decision making. Although proxy variables have the advantage of using objective data, they introduce noise into the estimation. For example, excessive employment is consistent with both a political use of firms, i.e., a political cost, and a manager's preference for empire building, i.e. an agency costs. Furthermore, political influence over firms' decision making is multifaceted and often obscure, so that commonly available objective data cannot portray accurately the overall level of political influence. On the other hand, using a survey to assess the extent of political influence takes a direct approach by gathering specific information available only to insiders. Therefore, studies based on respondents' assessments offer insights and evidence that would be unobtainable from proxy variables. Nonetheless, respondents' assessments may suffer from perception biases and, therefore, caution must be used when such data are employed to assure that the results are interpreted properly.

We employ respondents' assessments from SSES to construct measures of party control.⁷ SSES includes a question that asked respondents to rate the level of decision-making power of the major decision makers in the listed firms regarding 63 decisions on a five-point scale. Responses ranged from no involvement at all, i.e., a score of 1, to complete influence, i.e., a score of 5. A list of the decisions and the average decision-making power of the largest shareholders, local party committees, and managers is provided in [Appendix Table A](#). The decisions cover a wide range of issues, including finance and investment, appointment and dismissal of key personnel, performance appraisal, organizational change, strategic planning, and external relationships. This comprehensive coverage makes it less likely that content validity will pose a problem for our measures. We also assess the reliability of our data by testing the internal consistency of the ratings. The results presented in [Appendix Table A](#) indicate that our data are highly consistent, with Cronbach's alpha greater than 96 percent.⁸

We measure party control in two steps. First, based on the survey data, we construct indexes of average decision-making power for the local party committee, the largest shareholders, and managers as rated by respondents for each firm. The average decision-making power indexes of the local party committee (PI), the largest shareholders (SI), and man-

⁷ The respondents were secretaries of BoDs. In the management structure of China's listed firms, this position is similar to that of managing director in a Western firm in that the secretary is expected to know more about the firm than any other employee.

⁸ Systematic biases that may affect our results are unlikely to be a problem because respondents are unlikely to have perceived the specific linkage between party control and firm performance in the questionnaire, which contains 74 questions covering nearly every aspect of the corporate governance structure.

agers (MI) for these 63 decisions are calculated, respectively, as follows:

$$PI_i = \sum_{j=1}^n S_{ij}/n, \quad SI_i = \sum_{j=1}^n S_{ij}/n, \quad \text{and} \quad MI_i = \sum_{j=1}^n S_{ij}/n,$$

where S_{ij} is the level of involvement of decision maker i in decision j , rated on a five-point scale for these 63 decisions. In the process, we treat all decisions as equally important and assign them equal weights.

We use the ratio of the decision-making power index of the local party committee to that of the largest shareholders to measure party control over the largest shareholders and denote it PS. A high value of PS implies that the local party committee has more decision-making power than the largest shareholders and, therefore, it has more latitude to pursue political objectives relative to the goals of the largest shareholders. Similarly, we use the ratio of the decision-making power index of the local party committee to that of the managers to measure party control over managers and denote it PM.

We compare listed firms' performances using three measures, namely, return on asset (ROA), return on equity (ROE), and return on sales (ROS). Although the quality of accounting data may be questioned due to China's embryonic accounting standards, the use of market-based performance measures may be equally problematic because of the potential adverse effect of noise trading in an emerging stock market. Black (1985) shows that, without noise trading, very little trading will occur in individual assets so that more noise trading indicates a more liquid stock market. China's stock market has been characterized by extremely high turnover velocity, defined as the total transaction volume divided by total number of tradable shares. In 1999, the turnover velocity of stocks was about 420 percent. In other words, each stock changed hands 4.2 times per year on average, which indicates substantial noise trading. On the other hand, Morck et al. (1999) find that 80 percent of the stocks listed on China's two exchanges move in the same direction in a given week. This degree of synchronicity is the second highest among stock markets in 40 countries and suggests that stock prices in China tend to capitalize market-level information rather than firm-specific information. Furthermore, Pastor and Veronesi (2003) offer evidence that younger stocks and stocks that pay no dividends have higher market-to-equity ratios and more volatile returns because of uncertainty about average profitability. By the end of 1999, China's listed firms had an average listing age of 3.8 years and only 30.3 percent of firms paid dividends. The average price-to-earning ratio of firms listed on the A-share market of tradable shares was as high as 36.6. Therefore, we do not use a stock-market-based performance measure but focus only on accounting performance to evaluate the implications of party control. The accounting data were obtained from the Shanghai Wind Information Co., Ltd. (WIND). To further ensure data accuracy and consistency, we double-check our data against the financial data published in the annual reports of the listed firms.

We introduce control variables into our regression models to isolate the performance effects of party influence on decision making. The listed firms in our sample operate in a number of industries so that they are subject to different degrees of competition and regulation. In addition, they come from different localities having different degrees of both economic development and integration into the international economy. Varying industrial and local conditions provide firms with differing opportunities to earn profit and afford

different opportunities to the local party committees to use firms to serve political purposes (Opper et al., 2002; Wong et al., 2004). Therefore, we include industry dummies, denoted $INDUSTRY_i$, and locality dummies, denoted $LOCAL_j$, to capture the industry-specific and locality-specific conditions.⁹

The level of party control and firm performance are affected by a firm's size and its capital structure. Large firms have scale economies and better access to financial resources, which can improve firm performance. Xu and Wang (1999) and Qi et al. (2000) show that the size of China's listed firms is related positively to ROA and ROE. On the other hand, large firms are associated with a higher degree of political influence because they can deliver more benefits to politicians (Lioukas et al., 1993; Wong et al., 2004). Following Qi et al. (2000), we use the logarithm of book value of assets, denoted ASSET, to proxy firm size. We also introduce the debt-to-equity ratio, denoted DER, as a control variable. Qi et al. (2000) and Xu and Wang (1999) find that the debt-to-equity ratio in China's firms is related negatively to ROA. In addition, a positive relationship may exist between party control and the amount of bank credit a firm is able to obtain because the party network is an important channel for securing loans in China (McGregor, 2001). Qi et al. (2000) and Xu and Wang (1999) find that the performance of listed firms is associated negatively with the proportion of shares held by the state and positively with the proportion of shares held by legal persons. Hence, we include the percentage of state shares, denoted PSTATE, as a control variable to capture the possible difference between these two types of state shareholders.

Managers in China's listed firms are subject not only to party control but also to political control from state shareholders and from local governments and ministries. Political control from state shareholders is captured by the largest shareholder's decision-making power, and the possible difference between state shares and legal-person shares is captured by the control variable for state shareholding. However, the level of party control may also be correlated with control from local governments and ministries. Therefore, we introduce a dummy variable, denoted PAS, to indicate whether a listed firm has maintained official administrative relationship with local governments and ministries. This dummy variable is equal to one if a listed firm has maintained official ties with local government and ministries and zero otherwise.

We separate party control into control over the largest shareholders and control over managers. Since some managers are actually shareholders, we use percentage of shares held by managers, denoted MS, to capture any confounding impact. In our sample, 15.6 percent of the managers also held the position of party secretary. Because it is difficult to discern the objectives of party secretaries who are also managers and because these objectives may confound the investigated relationships, we introduce a dummy variable, denoted PCEO, to indicate the presence or absence of a manager who is also a party secretary. This dummy variable is equal to one if a party secretary also holds the position of manager and zero otherwise. Finally, the level of party control and firm performance may be endogenous because party control affects firm performance and firm performance

⁹ The industry code is obtained from China Securities and Futures Statistical Yearbook 2000, which provides a 12-industry classification. Our locality code comes from SSES, which classifies the locality of the listed firms into six groups.

influences the level of party control. To account for this reverse-causality, we include lag performance, denoted PL, as a control variable. Interaction terms between lag performance and each of the two types of party controls are also added and denoted as PLPS and PLPM, respectively.

Regarding data sources, the data for ASSET, DER, PSTATE, and PL are from WIND. The data for PAS and PCEO are from SSES; we collected the data for MS directly from the listed firms' annual reports. We estimate the following equation to determine the performance implications of party control:

$$P = \alpha + \sum_{i=1}^7 \lambda_i \text{INDUSTRY}_i + \phi_j \sum_i^5 \text{LOCAL}_j + \beta_1 \text{DER} + \beta_2 \text{ASSET} \\ + \beta_3 \text{PSTATE} + \beta_4 \text{PAS} + \beta_5 \text{MS} + \beta_6 \text{PCEO} + \beta_7 \text{PL} + \beta_8 \text{PLPS} + \beta_9 \text{PLPM} \\ + \beta_{10} \text{PS} + \beta_{11} \text{PM} + \varepsilon,$$

where P denotes the performance measure proxy, which is ROA, ROE, or ROS. Our hypotheses indicate that β_{10} should be significantly positive and β_{11} should be significantly negative. In the next section, we discuss sample selection and report our empirical results.

4. Empirical results

For the survey, researchers distributed questionnaires to 483 firms listed on the Shanghai Stock Exchange at the end of 1999. Of these firms, 257 returned the questionnaires, which amounts to a response rate of greater than 50 percent. We compare the survey data on basic firm characteristics, including listing age and industry, provided by respondents with data provided by annual reports. Of the 257 returned questionnaires, we exclude one because it contained inconsistent data. In addition, we exclude 6 firms because they were listed only on the B-share market and not on the main board of the A-share market. Of the remaining 250 firms, only 90 provide a complete set of ratings on the decision-making power of local party committees, the largest shareholders, and managers in all decisions. When we limit our sample to these firms, we have about 19 percent of the firms listed on the A-share market of the Shanghai Stock Exchange at the end of 1999.

We evaluate the representation of our sample firms in two steps. First, we compare the industries represented in our sample with the corresponding industrial structure of all firms listed on the A-share market of the Shanghai Stock Exchange. Second, we compare the sample means of the variables with the corresponding means of all listed firms. Table 2 presents the comparison of the industrial distribution. The firms listed on the exchange are distributed unevenly across industries. At the end of 1999, 58.6 percent of the firms belonged to the manufacturing industry, 10.8 percent belonged to the wholesale and retail industry, and 8.3 percent were conglomerates. The top three industries account for 77.7 percent of all the listed firms. The distribution of firms in our sample is similar to this distribution. Within our sample, 58.9 percent of firms belong to the manufacturing industry, 13.3 percent belong to the wholesale and retail industry and 8.9 percent are conglomerates. Our sample includes observations for only eight of the 12 industries represented on the exchange; the four unrepresented industries are agriculture, finance and insurance, mining

Table 2
Comparison of industrial distribution

Industries	SAMPLE ₉₉	ALL ₉₉
Agriculture	0 (0.00)	9 (1.91)
Mining/quarrying	0 (0.00)	3 (0.64)
Manufacturing	53 (58.89)	276 (58.60)
Production and supply of electric power gas and water	4 (4.44)	16 (3.40)
Construction	1 (1.11)	10 (2.12)
Transportation, storage, and postal	6 (6.67)	26 (5.52)
Wholesale and retail	12 (13.33)	51 (10.83)
Finance and insurance	0 (0.00)	4 (0.85)
Real estate	3 (3.33)	14 (2.97)
Social services	3 (3.33)	20 (4.25)
Media	0 (0.00)	3 (0.64)
Conglomerate	8 (8.89)	39 (8.28)
No. of firms	90 (100)	471 (100)

Notes. (1) The heading denoted SAMPLE₉₉ refers to our sample firms. (2) The heading denoted ALL₉₉ refers to all firms listed on the A-share market of the Shanghai Stock Exchange at the end of 1999. (3) The number of firms in the sample is 90. The total number of firms listed on the A-share market of the exchange is 471. (4) Percentages in parentheses.

and quarrying, and media. However, the number of listed firms in these four industries is relatively small; together they account for only about 4 percent of all firms. Therefore, our sample is reasonably representative of the overall industrial structure of firms listed on the exchange. Table 3 reports the means and standard deviations of the variables used for our sample firms and for all firms listed on the A-share market of the Shanghai Stock Exchange. *T*-tests indicate that the sample means of variables do not exhibit significant differences from the population means.

Among the largest shareholders, managers, and local party committees, managers enjoy the highest level of decision-making power with a mean of 3.04, followed by the largest shareholders, with a mean of 2.13, and local party committees with a mean of 1.61. Moreover, the decision-making power of the local party committee is weaker than that of the largest shareholders and managers with PS equal to 0.81 and PM equal to 0.53. Further analysis of the relative level of party control over the decisions of individual firms reveals that party control focused on personnel decisions, as the last column of Appendix Table A

Table 3
Descriptive statistics

Variables	Mean _{ALL}	S.D. _{ALL}	Mean _{Sample99}	S.D. _{Sample99}
Return on asset (ROA)	0.038	0.090	0.042	0.048
Return on equity (ROE)	0.068	0.461	0.069	0.156
Return on sales (ROS)	0.091	0.567	0.091	0.240
Lagged return on asset (ROA –1)	0.050	0.069	0.047	0.051
Proportion of state shares (PSTATE)	0.323	0.276	0.324	0.265
Debt to equity ratio (DER)	1.250	2.588	1.288	1.879
Logarithm of asset (ASSET)	20.798	0.873	20.819	0.900
Percentage of managerial shareholding (MS)	0.006	0.021	0.006	0.012
Party secretary managers (PCEO)			0.156	0.364
Presence of administrative superior (PAS)			0.589	0.495
Decision-making power of party committee (PI)			1.613	0.628
Decision-making power of manager (MI)			3.044	0.542
Decision-making power of the largest shareholder (SI)			2.134	0.685
Party control over managers (PM)			0.532	0.175
Party control over the largest shareholders (PS)			0.812	0.375

indicates. The five decisions over which local party committees exert the most control are the selection of functional department managers, the selection of business department managers, the selection of branch managers, the selection of subsidiary managers, and the selection and dismissal of vice chief executive officers. On the other hand, local party committees have the least influence over financial decisions. The five decisions over which local party committees exert the least control are changing shareholding structure, determining the amounts of loans for liquidity, determining share placement and new issues, changing debt/equity ratios, and formulating dividend plans.

Table 4 reports the Pearson correlation matrix for the variables. Among the independent variables, no correlation exceeds 0.7, which is the typical threshold to identify the presence of multicollinearity (Lind et al., 2002). To further ensure that multicollinearity is not a problem, we calculate variance inflation factors (VIF) for each independent variable. The VIFs, which are reported in the last three rows of Table 4, never exceed two appreciably so that they are significantly lower than the typical threshold of 10 (Belsley et al., 1980). Hence, we conclude that our regression analyzing the performance implication of party control for China's listed firms will not suffer from multicollinearity. Because our firms come from different industries, ordinary least squares (OLS) may be prone to a heteroscedasticity problem. Therefore, we report both OLS standard errors and White-adjusted OLS errors in Table 5 (White, 1980). Since consistent results are obtained from both, we discuss only those results based on OLS standard errors.

Consistent with the results of prior studies, we find a positive and significant size effect in the ROE and ROS regressions in Table 5. Although the coefficients for the debt/equity ratio are negative in all regressions, only the coefficient in the ROS regression is statistically significant. Even though the proportions of shares held by managers in China's listed firms are low, managerial shareholding is correlated positively with ROA, indicating that it may align a manager's interests with firm performance.

Table 4
Pearson correlation matrix

Variables	1	2	3	4	5	6	7	8	9	10	11
1 Return on asset (ROA)											
2 Return on equity (ROE)	0.822***										
3 Return on sales (ROS)	0.648***	0.617***									
4 Lagged return on asset (ROA-1)	0.640***	0.499***	0.293***								
5 Proportion of state shares (PSTATE)	0.018	-0.019	0.014	0.007							
6 Debt-to-equity ratio (DER)	-0.317***	-0.142	-0.163	-0.292***	0.154						
7 Logarithm of asset (ASSET)	-0.133	0.021	0.058	-0.035	0.217**	0.430***					
8 Percentage of managerial shareholding (MS)	0.230**	0.113	0.075	0.085	-0.151	-0.123	-0.210**				
9 Party secretary managers (PCEO)	-0.057	-0.034	-0.100	0.023	-0.222**	-0.053	-0.040	0.045			
10 Presence of administrative superior (PAS)	-0.047	-0.059	-0.119	0.000	0.205	0.219**	0.243**	0.066	-0.015		
11 Party control over managers (PM)	-0.258**	-0.189	-0.174	-0.218**	0.195	0.091	0.177	-0.175	-0.101	0.242**	
12 Party control over the largest shareholders (PS)	-0.107	-0.048	-0.010	-0.269**	-0.014	0.049	0.049	-0.064	-0.112	0.136	0.625***
VIF (ROA as dependent variable)				1.265	1.407	1.542	1.476	1.249	1.183	1.330	2.002
VIF (ROE as dependent variable)					1.409	1.409	1.481	1.249	1.183	1.325	2.001
VIF (ROS as dependent variable)						1.415	1.442	1.468	1.247	1.206	1.320

** Significance at the 5% level using a two-tail criterion.

*** Idem., 1%.

Table 5
Performance implications of party control for listed firms

	ROA Model 1	ROE Model 2	ROS Model 3
(Constant)	−0.063 (0.127) (0.118)	−0.977 (0.427)** (0.474)**	−1.361 (0.750)* (0.706)*
Industry dummies (INDUSTRY)	Yes	Yes	Yes
Locality dummies (LOCAL)	Yes	Yes	Yes
Debt-to-equity ratio (DER)	−0.004 (0.003) (0.002)**	−0.004 (0.009) (0.008)	−0.029 (0.016)* (0.015)*
Logarithm of asset (ASSET)	0.005 (0.006) (0.006)	0.056 (0.020)*** (0.026)**	0.081 (0.035)** (0.038)**
Proportion of state shares (PSTATE)	0.020 (0.018) (0.015)	0.032 (0.061) (0.045)	0.093 (0.107) (0.121)
Presence of administrative superior (PAS)	0.001 (0.009) (0.007)	−0.004 (0.031) (0.020)	−0.025 (0.054) (0.039)
Percentage of CEO shareholding (MS)	0.770 (0.370)** (0.300)***	1.786 (1.247) (0.526)***	2.666 (2.189) (1.413)*
Party secretary managers (PCEO)	−0.005 (0.012) (0.010)	−0.003 (0.041) (0.025)	−0.039 (0.072) (0.075)
Lag performance (ROA-1)	0.319 (0.344) (0.559)	−1.534 (1.160) (1.704)	−1.285 (2.036) (1.887)
Interaction between lag performance and control over managers (PLPM)	0.975 (0.767) (1.032)	11.397 (2.586)*** (6.258)*	4.476 (4.538) (5.257)
Interaction between lag performance and control over the largest shareholders (PLPS)	−0.295 (0.381) (0.385)	−3.26** (1.284)** (2.028)	−0.040 (2.253) (1.748)
Party control over managers (PM)	−0.121 (0.045)*** (0.050)**	−0.711 (0.153)*** (0.299)**	−0.726* (0.268)*** (0.200)***
Party control over the largest shareholders (PS)	0.040 (0.018)** (0.020)**	0.207 (0.059)*** (0.101)**	0.238 (0.104)** (0.084)***
No. of firms	90	90	90
Adjusted <i>R</i> -square	0.421	0.385	0.200
<i>F</i>	3.693	3.318	3.046

Notes. Standard errors are reported in parentheses. The OLS standard errors are in the first row and the White-adjusted errors are in the second row.

* Significant at the 10% level.

** Idem., 5%.

*** Idem., 1%.

Turning to the variable of interest, the coefficients for party control of shareholder are positive in all regressions, with statistical significance at the one-percent level for ROA and ROE regressions and at the five-percent level for the ROS regression. Hence, our hypothesis that party control over the largest shareholders has a positive impact on firm performance is supported. On the other hand, the coefficients measuring party control over managers are negative in all regressions and statistically significant at the one-percent level. Therefore, our hypothesis that party control over managers has a negative impact on firm performance is also supported. Since party control over the largest shareholders and over the managers is associated with different balances between political costs and incentive costs, the difference in the magnitudes of these two coefficients does not imply that expropriation problems are more serious than agency problems. However, because the absolute values of the coefficients on control over managers are greater than those on control of the largest shareholders, our results suggest that reducing the existing level of party control will improve the performance of listed firms.¹⁰

5. Conclusion

In this paper, we examine the impact of the involvement of local party committees in the decision making of China's listed firms on firm performance. We show that party control over the largest shareholders is associated positively with firm performance, which suggests it mitigates expropriation problems. We also find that party control over managers is associated negatively with firm performance, which supports the hypothesis of [Boycko et al. \(1996\)](#) that managers are more concerned with profits than are politicians. Balancing the performance implications of party control over shareholders and managers, our results indicate that reducing the overall level of local party committees' decision-making power should improve firm performance. However, we have three caveats relating to the generalization of our results.

First, shareholders in listed firms in China are mainly state entities that are likely to share some of the political objectives of the local party committees. If the largest shareholders are private investors, party control will generate higher political costs so that the net effect of party control may not be positive. Therefore, our finding relating to party control over the largest shareholders may not be applicable. Second, the incentive problems of controlling shareholders and managers in listed firms may be less serious than in non-listed firms. Shareholders and managers in listed firms are subject to monitoring by the disciplinary forces of the stock market and the regulations of the China Securities and Regulatory Commission. Hence, a difference in the degree of incentive problems implies that the optimal level of party control in listed and non-listed firms may be different. Therefore, caution must be exercised when generalizing our results to non-listed firms in China. Third, in recent years, the Chinese government has sought a more effective corporate governance structure to protect the interests of minority shareholders. For example, it established a system of independent directors and imposed regulations constraining

¹⁰ The overall performance implication of party control in China's listed firms is consistent with finding obtained by [Wong et al. \(2004\)](#).

related-party transactions. If these measures prove effective in containing shareholders' expropriation problems, positive role played by the local party committees in listed firms will diminish over time thanks to improved corporate governance in China.

Acknowledgments

This research is supported by the Hong Kong Research Grants Council (RGC) Competitive Earmarked Research Grant Awards 2002–2003 (HKU7173/02H). It is also partially supported by the Area of Excellence Scheme funded by RGC (AoE/H-05/99). We thank three anonymous referees and Barick Chung for their valuable suggestions. This paper benefited immensely from insightful comments from our editor, John P. Bonin. Kalok Yuen provided excellent research assistance.

Appendix Table A
Types of decisions and reliability test

No.	Decisions	Largest shareholder	Manager	Party	Rank of party power
1	Call of shareholder meeting	3.056	2.144	1.411	44
2	Agenda setting in shareholder meeting	2.989	2.156	1.367	46
3	Call of board meeting	2.711	2.322	1.389	45
4	Agenda setting in board meeting	2.578	2.400	1.422	43
5	Call of supervisory committee meeting	2.133	1.689	1.511	38
6	Agenda setting in supervisory committee meeting	1.944	1.678	1.500	39
7	Call of manager's office meeting	1.689	4.578	1.767	17
8	Agenda setting in manager's office meeting	1.678	4.589	1.767	18
9	Selection of representatives attending manager's office meeting	1.489	4.567	1.656	25
10	Making amendments to firm's charter	2.600	2.167	1.433	42
11	Organizational change	2.111	3.511	2.000	6
12	Creation and abolition of functional departments	1.722	3.989	1.989	8
13	Selection of functional department manager	1.633	4.389	2.144	1
14	Performance appraisal of functional departments	1.511	4.411	2.022	5
15	Creation and abolition of business departments	1.567	4.378	1.889	11
16	Selection of business department managers	1.533	4.411	2.133	2
17	Performance appraisal of business department	1.467	4.389	2.000	7
18	Creation and abolition of branch	1.811	3.789	1.767	19
19	Selection of branch manager	1.689	4.256	2.044	4
20	Performance appraisal of branch	1.600	4.300	1.878	13
21	Creation and abolition of subsidiaries	1.844	3.589	1.800	16
22	Selection of subsidiary manager	1.622	4.056	2.056	3
23	Performance appraisal of subsidiaries	1.544	4.167	1.911	10
24	Election and dismissal of chairman of board of directors	3.156	1.400	1.589	30

(continued on the next page)

Appendix Table A (Continued)

No.	Decisions	Largest shareholder	Manager	Party	Rank of party power
25	Performance appraisal and remuneration of board chairman	2.711	1.444	1.589	31
26	Election and dismissal of board members	2.944	1.433	1.544	37
27	Performance appraisal and remuneration of board members	2.456	1.467	1.578	33
28	Election and dismissal of board secretary	2.300	1.844	1.600	29
29	Performance appraisal and remuneration of board secretary	2.056	2.067	1.622	27
30	Selection of supervisory committee members	2.689	1.544	1.744	21
31	Performance appraisal and remuneration of supervisory committee members	2.400	1.600	1.689	22
32	Selection and dismissal of chief executive officer	2.533	1.856	1.844	14
33	Performance appraisal and remuneration of chief executive officer	2.211	1.967	1.767	20
34	Selection and dismissal of vice-chief executive officer	2.111	3.267	1.978	9
35	Performance appraisal and remuneration of vice-chief executive officer	1.944	3.156	1.889	12
36	Change in shareholding structure	2.878	2.211	1.356	51
37	Change in debt/equity ratio	2.600	2.567	1.300	61
38	Formulation of dividend plan	2.700	2.411	1.256	63
39	Determining share placement and new issue	2.722	2.500	1.278	62
40	New investment in technology	2.256	3.289	1.367	47
41	New investment in infrastructure	2.256	3.200	1.367	48
42	Financial investment	2.078	3.067	1.322	58
43	Investment in other stock firms	2.278	2.989	1.344	53
44	Sale of assets	2.256	2.944	1.367	49
45	Determining loans for fixed asset investment	1.967	3.400	1.344	54
46	Determining loans for liquidity fund	1.844	3.689	1.311	60
47	Determining loans through mortgaging of assets	2.111	3.011	1.356	52
48	Guarantee for other enterprises' large-scale loans	2.122	2.889	1.333	56
49	Determining amount of external donation	1.856	3.011	1.578	34
50	Formulation of external donation plan	1.800	3.178	1.667	24
51	Contracting of large-scale construction projects	1.811	3.478	1.467	40
52	Merging with other enterprises	2.500	2.956	1.467	41
53	Being merged with by other enterprises	2.822	2.767	1.589	32
54	Formulation of long-term development plan	2.322	3.300	1.633	26
55	Formulation of strategic plan	2.289	3.333	1.611	28
56	Establishment of long-term relationship with other enterprises	1.956	3.656	1.556	36
57	Change of direction; entry into new industry and market	2.367	3.333	1.567	35
58	Selection of accounting (auditing) firm	1.933	2.589	1.322	59

(continued on the next page)

Appendix Table A (Continued)

No.	Decisions	Largest shareholder	Manager	Party	Rank of party power
59	Selection of law firm	1.856	2.833	1.333	57
60	Selection of financial consultant	1.722	3.033	1.344	55
61	Selection of management consultant	1.756	3.322	1.367	50
62	Training and education for board members and higher management	1.778	2.933	1.678	23
63	Training and education for middle management	1.567	4.233	1.822	15
	Average of decision-making power	2.134	3.033	1.613	
	Cronbach's alpha	0.983	0.959	0.986	

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