

# **The Institutional Change in China after its Reform in 1979**

**An Institutional Analysis with a Focus on Mergers and Acquisitions**

ISBN 9-0567-7255-4

CHERC-Publication Series  
Erasmus University Rotterdam  
PO Box 1738, Office E1-01  
3000DR Rotterdam  
The Netherlands

Email: [CHERC@few.eur.nl](mailto:CHERC@few.eur.nl)

© 2004 Y. Fei, Rotterdam. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any mean, electronic, mechanical, photocopying, recording, or otherwise, without the prior permission in writing from the proprietor.

# **The Institutional Change in China after its Reform in 1979**

## **An Institutional Analysis with a Focus on Mergers and Acquisitions**

Institutionele verandering in China na de hervorming van 1979  
Een institutionele analyse met een focus op fusies en overnames

PROEFSCHRIFT

TER VERKRIJGING VAN DE GRAAD VAN DOCTOR  
AAN DE ERASMUS UNIVERSITEIT ROTTERDAM  
OP GEZAG VAN DE RECTOR MAGNIFICUS

PROF.DR. S.W.J. LAMBERTS

EN VOLGENS BESLUIT VAN HET COLLEGE VOOR PROMOTIES.

DE OPENBARE VERDEDIGING ZAL PLAATS VINDEN OP  
DONDERDAG 18 NOVEMBER 2004 OM 13.30 UUR

DOOR

**YIWEN FEI**

GEBOREN TE SHANGHAI, P.R.CHINA.

## **Promotiecommissie**

Promotor: Prof.dr. J.P.M. Groenewegen  
Overige leden: Prof.dr. M.P. van Dijk  
Prof.dr. W.M. Lammerts van Bueren  
Prof.dr. R.J.M. van Tulder  
Copromotor: Dr. O.W. Steenbeek

## Preface

When packing my suitcases for the trip to Rotterdam once again, I realised that this would be the last trip for my doctoral research abroad. After participating in the Ph.D. Masterclass, which was organised by the China-Holland Education & Research Centre (CHERC) at Erasmus University Rotterdam in July and August 1999, I won the position of Ph.D. candidate in the school of economics, Erasmus University Rotterdam. Since then I have been flying between Shanghai and Rotterdam from time to time.

Pursuing a PhD study abroad is not an easy task. In writing this dissertation, I encountered a lot of difficulties. Fortunately, many persons kindly helped me to finish this programme. My thanks go to all of them.

My dissertation is a combination of theoretical research and empirical study. I owe my thanks to my supervisors. Without their help, my dissertation would never have been finished. First of all, I would like to express my sincere gratitude to my promoter, Prof.dr. J.P.M. Groenewegen. Prior to my entrance to EUR, I always wondered: why China cannot be listed as one of the most wealthy and powerful countries in the world though she has the most diligent people. It is John who led me into the world of Institutional Economics. "Institutions do matter." I still remember that we discussed from sunrise till sunset at his home in Delft. And, he was so kind to offer me his own office in Erasmus University. Especially for the final touches of my dissertation, John spent an enormous amount of time reading the draft one after another and correcting it word by word.

I would like to convey my special thanks to Dr. Onno Steenbeek, my copromoter. He is an expert in the field of Asian Finance and I benefited a lot from discussions with him on financial research. Although he was busy in his work in both EUR and ABP Investments, I always received a lot of help from him. He supplied me with the study methodology and database to support my research. My work would not have been successfully finished without his knowledge and help.

Though the completion of my PhD program is approaching, I hope the cooperation with John and Onno in the academic field will continue. Moreover, I hope to see more educational communication between China and the Netherlands and will do whatever I can to support this.

My thanks also go to Prof.dr. M.P. van Dijk, Prof.dr. W.M. Lammerts van Bueren and Prof.dr. R.J.M. van Tulder, who are members of the small committee. They spend a lot of time and energy to read this thesis and gave me their comments.

I owe much gratitude to Prof.dr. W.M. Lammerts van Bueren, Chairman of the China-Holland Education & Research Centre (CHERC). He did build a bridge between China and the Netherlands. He led me into Erasmus University Rotterdam and guided me from the beginning to the end, allowing me to complete the PhD project in an efficient and fruitful way. I also would like to thank CHERC for sponsorship and Mrs. Weichia Tseng for arranging working facilities and

accommodation during my stay in Rotterdam. I would like to thank Shanghai Jiao Tong University for giving me this opportunity to carry out my research.

My gratitude also goes to the "Hoogeschool-Fonds 1920" for the financial support of my PhD-project. The generous help of this Foundation has been crucial in completing this thesis.

I am very grateful to my parents for their care and love that enabled me to pursue a PhD study abroad. They encouraged me to work hard. Otherwise I would not have been able to finish this programme in 4 years and get the PhD degree overseas.

Last, but definitely not least, I am deeply indebted to my wife Yun. I would not have been successful in this PhD project without her love and encouragement. Since I started my study abroad, she shared life as well as work pressure. When I met problems in my studies or in life, she always encouraged me to look forward and go ahead. I dedicate this dissertation to her.

Yiwen Fei

Rotterdam September 29<sup>th</sup> 2004

# Contents

List of Figures

List of Tables

<b>1 Introduction, Research Question and Methodology.....</b>	<b>1</b>
Introduction.....	1
1.1 China's Transformation Economy.....	4
1.1.1 China's achievements.....	4
1.1.2 China's challenges .....	8
1.1.3 Restructuring the corporate sector: the role of mergers and acquisitions in China .....	12
1.2 The Research Question: Institutional Economics and China's Reform .....	15
1.2.1 The research question.....	16
1.2.2 The theoretical framework .....	17
1.2.3 The research method .....	21
1.3 Overview of the Thesis .....	22
<b>2 China's Centrally Planned Economy .....</b>	<b>25</b>
Introduction.....	25
2.1 Informal Institutions in the Chinese Centrally Planned Economy .....	26
2.2 Formal Institutions.....	29
2.2.1 The economic strategy of a Centrally Planned Economy .....	29
2.2.2 The development of the centrally planned economic system in China .....	31
2.2.3 The governance structure .....	35
2.3 Concluding Remarks: the Failure of Chinese Planned Economy .....	38
<b>3 China's Transformation Economy .....</b>	<b>41</b>
Introduction.....	41
3.1 Drivers of Change.....	41
3.1.1 The economic drivers.....	42
3.1.2 Political drivers .....	46
3.2 Formal Institutions.....	48
3.2.1 Setting the goal for a market system.....	48
3.2.2 Establishing the rule of law.....	50
3.2.3 Macroeconomic policy.....	51
3.2.4 The social security system .....	56

3.3	The Governance Structure in China's Transformation Economy .....	57
3.3.1	Corporate governance: some definitions.....	58
3.3.2	Privatising agriculture .....	60
3.3.3	Restructuring China's industry .....	62
3.4	Concluding Remarks.....	79
<b>4</b>	<b>China's Emerging Market for M&amp;A .....</b>	<b>81</b>
	Introduction.....	81
4.1	Historical Development of China's Mergers and Acquisitions Market.....	82
4.2	Mergers and Acquisitions in China's Stock Market .....	85
4.3	The Institutional Environment of M&A .....	92
4.3.1	The legal framework .....	94
4.3.2	Acquiring SOEs, collective and joint stock firms.....	96
4.3.3	The role of banks and stock markets.....	98
4.4	Driving Forces behind Mergers and Acquisitions .....	100
4.4.1	China's gradual reform approach.....	100
4.4.2	Business competition .....	106
4.5	Concluding Remarks.....	106
<b>5</b>	<b>Takeovers in China: empirical tests .....</b>	<b>107</b>
	Introduction.....	107
5.1	Review of Literature .....	108
5.1.1	M&A and shareholder wealth creation .....	109
5.1.2	Sources of wealth increase .....	111
5.1.3	M&A and Agency Theory .....	114
5.1.4	The market for corporate control in emerging markets .....	118
5.2	Data and Research Methodology .....	120
5.2.1	Introduction.....	120
5.2.2	Data .....	120
5.2.2	Methodology .....	124
5.3	Empirical Results 1: price and volume effects.....	125
5.3.1	Price effects.....	125
5.3.2	Trading volume effects .....	128
5.4	Empirical Results 2: discipline versus synergy.....	129
5.4.1	Results approach 1: accounting performance target company.....	129
5.4.2	Results approach 2: management turnover around takeovers.....	132
5.4.3	Summary .....	134
5.5	Managerial Objectives .....	135
5.5.1	Financial performance of bidding firms around the takeover announcement .....	135
5.5.2	The effect of takeovers on shareholder's wealth.....	137
5.5.3	Compensation of top management.....	139



5.5.4	Conclusions .....	140
5.6	Concluding Remarks .....	141
Appendix A	Calculation Cumulative Abnormal Returns (CARs).....	142
<b>6</b>	<b>The Institutional Approach to M&amp;A in China .....</b>	<b>145</b>
	Introduction.....	145
6.1	Institutional Economics.....	146
6.1.1	New Institutional Economics .....	146
6.1.2	M. Aoki and D. North .....	150
6.1.3	Original Institutional Economics .....	154
6.2	The Theory of Path Dependency .....	157
6.2.1	Path dependence.....	157
6.2.2	“On-path” and “Off-path” .....	160
6.2.3	Towards a dynamic framework.....	162
6.3	The Application on the Process of M&A in China.....	168
6.3.1	Pre-reform .....	170
6.3.2	Fourteen years’ of incremental reform (“on-path”) .....	172
6.3.3	“Off-path” on the way .....	179
6.4	Concluding Remarks.....	191
<b>7</b>	<b>Conclusions .....</b>	<b>193</b>
	Introduction.....	193
7.1	Overview of the Thesis .....	193
7.2	Research Conclusions .....	197
7.2.1	The CPE in the pre-reform period.....	197
7.2.2	The nature of the transition process .....	198
7.2.3	The present stage of the transition process .....	199
7.2.4	About the future of the system .....	199
	<b>References .....</b>	<b>203</b>
	<b>Samenvatting (Summary in Dutch).....</b>	<b>221</b>
	<b>Curriculum Vitae .....</b>	<b>227</b>

## List of Figures

Figure 1.1	Four-layer Schema in Institutional Economics .....	3
Figure 1.2	Growth Rate of China's Transformation Economy .....	5
Figure 1.3	Share of Non-state-owned Sector in Total Gross Industrial Output in China .....	7
Figure 1.4	Foreign Direct Investment .....	9
Figure 1.5	M&A in China's Stock Market .....	14
Figure 1.6	Overview of the Dissertation Structure .....	24
Figure 2.1	The Governance Structure of State-owned Enterprise (Danwei).....	36
Figure 3.1	The Growth Rate of China's Planned Economy .....	45
Figure 3.2	The Development of Listed Companies in China (1991 - 2003) .....	55
Figure 3.3	Laws and Regulations for Wholly Domestically Funded Enterprises and Businesses.....	64
Figure 3.4	The Number of State Employment (1991 - 2003).....	68
Figure 3.5	Growth Rates of Real Industrial Output in China 1985, 1990-1999..	75
Figure 4.1	Ownership Structure in China .....	86
Figure 4.2	The Profitability of the Firm in China.....	86
Figure 4.3	The Process of the Acquisition by Agreement.....	91
Figure 4.4	The Legal Framework of M&A for China's Listed Companies .....	96
Figure 4.5	The Driving Forces behind M&A from the Reform .....	101
Figure 5.1	Deal Characteristics Over Time .....	122
Figure 5.2	Monthly Number of Takeovers in China (1997 - 2003) .....	122
Figure 5.3	CARs of Chinese Targets around the Announcement Date.....	126
Figure 5.4	Excess Trading Volume around the Announcement Date .....	128
Figure 5.5	Bidders' CARs around the Announcement.....	138
Figure 6.1	Institutional Layers.....	148
Figure 6.2	Embedded Layers of Institutions.....	154
Figure 6.3	A Dynamic Framework for the Change of Governance Structure...	162
Figure 6.4	The Complementarities Among Ideology .....	163
Figure 6.5	The Path Dependency of China's M&A in a Dynamic Framework	169
Figure 6.6	Corporate Governance Structure in China .....	185

## List of Tables

Table 2.1	China's Historical Growth Record .....	31
Table 3.1	Structural Characteristics of China's and Other Economics (1980)...	43
Table 3.2	Intermediate Input Levels per Dollar of GNP (1979 - 1980) .....	44
Table 3.3	China's Living Standard per Capita in 1978 .....	45
Table 3.4	Classification of Enterprises by Ownership .....	63
Table 3.5	Corporate Internal Governance Structure .....	78
Table 4.1	M&A in China's Stock Market.....	88
Table 4.2	Frequency Statistics of M&A in China's Stock Market (1997 - 2003) .....	88
Table 4.3	Pensions for Retired and Resigned Person .....	104
Table 5.1	Chinese Domestic Takeovers (1997 - 2003):descriptive statistics ...	121
Table 5.2	List of the 14 merger cases in Chinese stock exchanges (1998 - 2001) .....	123
Table 5.3	CARs for Chinese Targets (1997 - 2003).....	126
Table 5.4	CARs for Chinese Targets (1997 - 2003): univariate analysis .....	127
Table 5.5	Excess Volume (EV) for Chinese Targets (1997 - 2003).....	129
Table 5.6	Non-Adjusted Financial Indicators .....	130
Table 5.7	Industry-Adjusted Financial Indicators .....	130
Table 5.8	Changes in Industry-adjusted Performance Indicators .....	132
Table 5.9	Top Management Turnover around Takeovers .....	132
Table 5.10	The Origin of New Appointed Chairman of the Board and Top Managers .....	134
Table 5.11	Financial Indicators of Bidding Firms.....	136
Table 5.12	The Change in Performance Indicators .....	137
Table 5.13	CARs for Chinese Bidders (1997 - 2003).....	138
Table 5.14	Managerial Ownership and Wealth .....	139
Table 5.15	Regression Results.....	140
Table 6.1	Designated Contractors in SOEs .....	177
Table 6.2	The Share Structure (1992 - 2003) .....	186
Table 6.3	The Concentration of Stocks .....	187

## Abbreviations

ACC	American Chamber of Commerce
ADB	Asian Development Bank
AMC	Asset Management Company
BSAM	The Bureau of State-owned Asset Management
CAR	Cumulative Abnormal Returns
CBRC	China Banking Regulatory Commission
CCP	Chinese Communist Party
CEEFSU	Central and Eastern Europe and the Former Soviet Union
CIRC	China Insurance Regulatory Commission
CPE	Centrally Planned Economy
CSRC	China Securities Regulatory Commission
EV	Excess Volume
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
IPO	Initial Public Offering
M&A	Merger and Acquisition
MOF	Ministry of Finance
NCE	Neoclassical Economics
NIE	New Institutional Economics
NPL	Non-performing Loan
OIE	Original Institutional Economics
PBOC	People's Bank of China
PPP	Purchasing Power Parity
PRC	People's Republic of China
ROE	Return on Equity
SASAC	State-owned Assets Supervision and Administration Commission of the State Council
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange
SOEs	State-owned Enterprises
SSB	China State Statistics Bureau
TCE	Transaction Cost Economics
TVE	Town and Village-owned Enterprise
UNDP	United Nations Development Programme
WTO	World Trade Organization