

## **Chapter One**

### **Introduction, Research Question and Methodology**

---

#### **Introduction**

The twentieth century witnessed two big transformations of economic systems around the world. The first was the transition from a capitalist market system to a socialist centrally planned system in China, the former Soviet Union, East European countries and some other countries. The second is a transition in the opposite direction, from a centrally planned system to a market system. This transition, starting in the late 1970s, is still in progress.

There seems to be an agreement about the necessary reforms to make the change from a planned economy to a market economy a success. The necessary ingredients are stabilisation, liberalisation, and privatisation, and political democratisation (Qian, 2002). Although many economists may not consider this recipe sufficient to guarantee an effective and efficient reform, few would question its necessity. All these ingredients have to do with institutions to be defined as the informal and formal “rules of the game”.

In Figure 1.1 the Economics of Institutions (Williamson, 1998) is presented to show how institutions can be distinguished in different layers and how the layers are related. The general idea of institutional economics is to show the importance of institutions in guiding behaviour of economic actors. Different institutional structures then result in different performances. The first layer refers to the informal institutions: values, norms, attitudes and the like. In order to understand the performance of for instance the Chinese economy in the period after 1979, it is suggested that a good knowledge of the ruling informal institutions is necessary. The second layer refers to the formal institutions: the legal rules and laws that forbid, allow or stimulate specific behaviour of economic actors. Corporate law and competition law are examples of these formal “rules of the game”, that are

important in studying the institutional structure of a country. The third level concerns the so-called “institutional arrangements”: the institutions of organisation (firms, alliances) and contracts that coordinate the cooperative and competitive behaviour of economic actors. Finally at the fourth level Williamson locates the market as the institution that coordinates demand and supply.

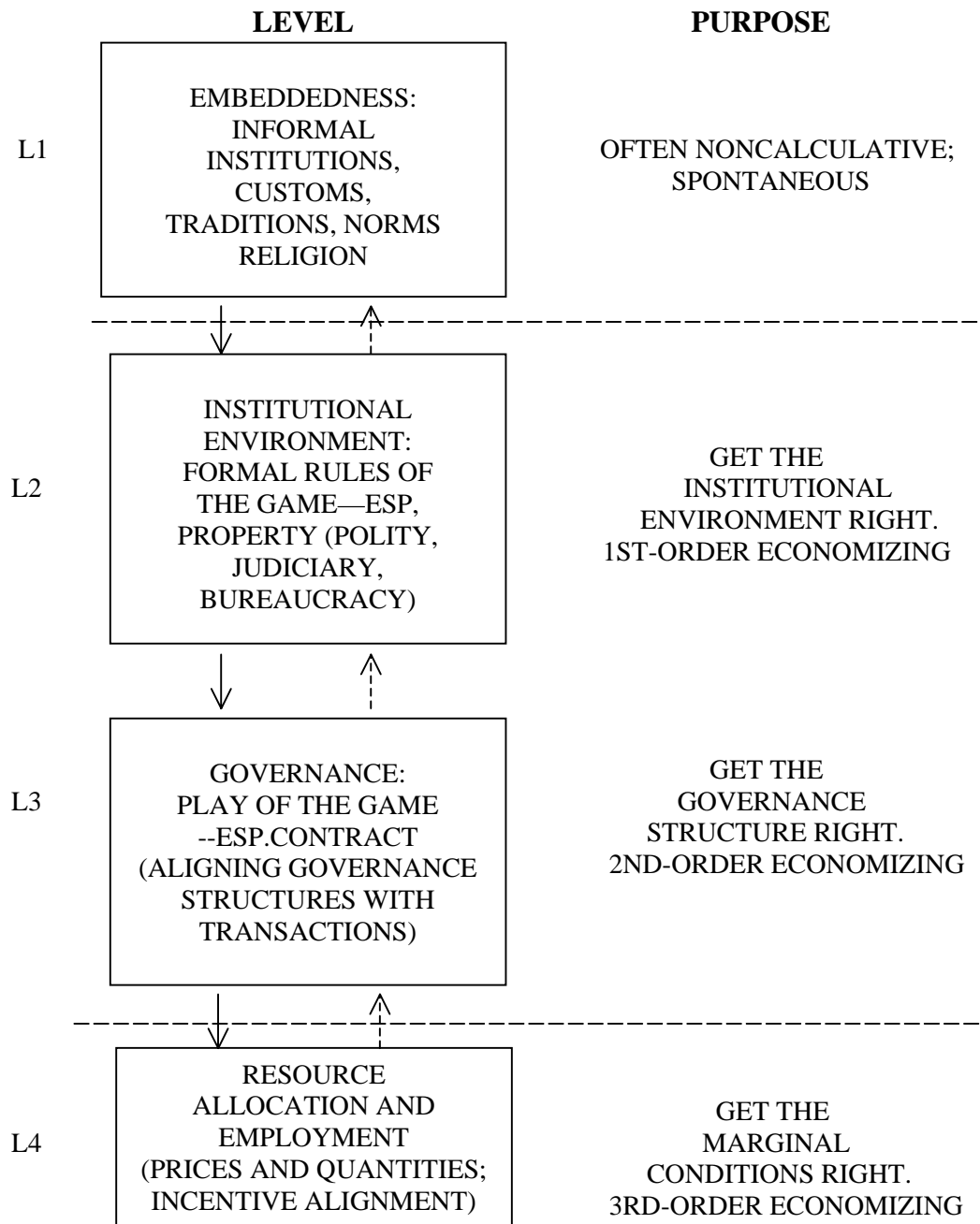
In Figure 1.1 Williamson also indicates the type of theories that are useful to study the institutions at the different layers: Neoclassical Theory and Agency Theory for Level four in which a marginal analysis is central, Transaction Cost Economics (TCE) for Level three at which the discrete choice between arrangements is the focus and finally Property Rights for Level two and “social theories” for Level one. Also an indication is provided concerning the period that the institutions are supposed to change. In Chapter 6 we will extensively discuss this four-layer schema; in this introduction we briefly outline how this schema is useful for our research question and why we prefer to make a distinction between two paradigms in institutional economics, namely the New Institutional Economics (NIE) and the Original Institutional Economics (OIE).

In New Institutional Economics (Coase, 1992; North, 1990; and Williamson, 1985), it is recognised that an efficient market economy requires not only markets that “get the prices right” (Level four), but also policies that get “the institutional arrangements right” (Level three). Moreover, it is assumed that other disciplines like sociology and political science, advise actors how to “get the informal and formal institutions right”. In New Economic Institutionalism, the set of institutions considered critical for sustainable economic growth include property rights protected by law, impartial enforcement of contracts through an independent judiciary, appropriate government regulations to foster market competition and effective corporate governance, transparent financial systems, and the like. The central idea being: when the institutional structure clearly defines the rules of the game, the actors are forced to apply the most efficient solutions.

In Original Economic Institutionalism, the focus is on understanding the dynamics of institutions recognising the importance of history, culture and path dependencies. Then the first two layers of Figure 1.1 are prominent in the analysis and – of crucial importance – the interdependencies and feedbacks between the layers. This makes OIE appropriate for another kind of research questions than the NIE is designed for and consequently applies different research methods than the mainstream economics of the neoclassical and the NIE.

From the perspective of New Institutional Economics the reforms in China and the economic performance of the last decade are puzzling, because measures about property rights, liberalisation, privatisation and democratisation have not, or not sufficiently, been taken. Nevertheless the Chinese economy performs impressively in terms of economic growth. It is not surprising that China’s reforms have been viewed as an anomaly and thus have not been thoroughly analysed by mainstream economists.

**Figure 1.1 Four-layer Schema in Institutional Economics**



Source: Williamson, O.E. (1998, p.26)

China did not fit in the general description of the report. The World Bank only gave China short comments in its World Development Report on transition economies (World Bank, 1996), because it couldn't figure out where to put China on the various measurement parameters. Blanchard and Fischer (1993) also asked themselves why China was growing so fast while conditions thought to be necessary for growth were absent. This thesis seeks to explore the nature of the transition in China and to explain why it is possible that the economic growth is so impressive without the reforms that economist normally deemed necessary. Especially we will focus on the restructure of state-owned enterprises with M&A as its instrument.

In the remainder of this chapter first the performance of the Chinese economy is outlined, then the central research question is presented, followed by an explanation of the role of NIE and OIE in our analysis and the research methodology; this chapter ends with an overview of the structure of the thesis.

## **1.1 China's Transformation Economy**

The reforms in China of the last decades have changed the institutional landscape fundamentally. Both informal institutions of values, norms and attitudes, and formal institutions of laws and regulations show major changes. Nowadays, competition, private ownership and individual gains are highly valued, whereas also formal aspects like property rights and competition policy is oriented to a so-called "socialist market economy". However, as to be analysed in this research, China follows its own path of economic and political reform, which is quite different from what in the West is taken to be a market economy.

We aim at an analysis of the economic system and focus on the restructuring of State Owned Enterprises (SOEs), because these firms form the core of the system. M&A plays an important role in the restructuring of SOEs. Most listed firms in China are re-formed from SOEs and the state holds controlling rights. The stock market is initially designed by the authority as the financial channel to SOEs and should be serve SOEs' reform. In our empirical studies in Chapter 5 we analyse the Enterprises listed on the two national stock markets and try to understand the influence of M&A on the performance of the enterprises. We believe the transfer of the state-owned controlling rights has an important effect on the restructuring of SOEs and China's transform economy.

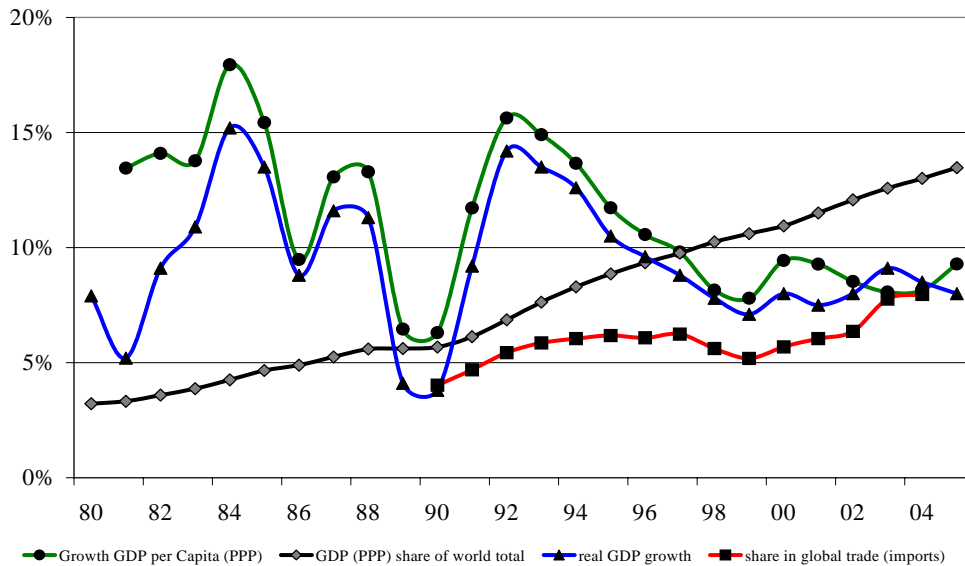
### **1.1.1 China's achievements**

China has achieved very high economic growth and made significant progress in establishing well-defined property rights.

*Economic growth*

By any standard, China has achieved spectacular economic successes after 1979. China has transformed itself from a poor, centrally planned economy to a lower middle-income, emerging market economy. With Real Gross Domestic Product (GDP) growing at an average annual rate of about 9%, China's per capita GDP has more than quadrupled during this period. Both China's growth rates in Real GDP and GDP per capita are higher than the global average for the past ten years (see Figure 1.2). The number of People living in absolute poverty has substantially reduced in the number of the population as well as their life expectancy has increased from 64 in the 1970s to over 70 in 2001 (United Nations Development Programme (UNDP), 2003).

**Figure 1.2 Growth Rate of China's Transformation Economy**



Source: Data are from the IMF website (September 2004)<sup>1</sup> and from DataStream.

Note: All growth figures are based on data quoted in US\$.

China's growth is not just another successful growth story because China is not an average country. China's economy is the largest developing economy, making the transformation from plan to market. It has a population three times larger than all other transition economies combined, including the 15 former Soviet Republics<sup>2</sup>. In 2000, its \$1 trillion economy was already bigger than all other transition economies combined. The cumulative effects of the two decades' growth are significant: a

<sup>1</sup> <http://www.imf.org/external/pubs/ft/weo/2004/01/data/index.htm>

<sup>2</sup> All economic indicators in this paragraph are from *Human Development reports 2003*, United Nations Development Programme (UNDP).

## *Chapter 1*

comparison with its two largest neighbours Russia and India gives an indication. With respect to total GDP, in terms of purchasing power parity, in 1988 China was less than half of Russia but in 2001 Russia was less than one fifth of China; On per capita basis, two decades ago China and India were about equal, but now China is about twice as rich as India.

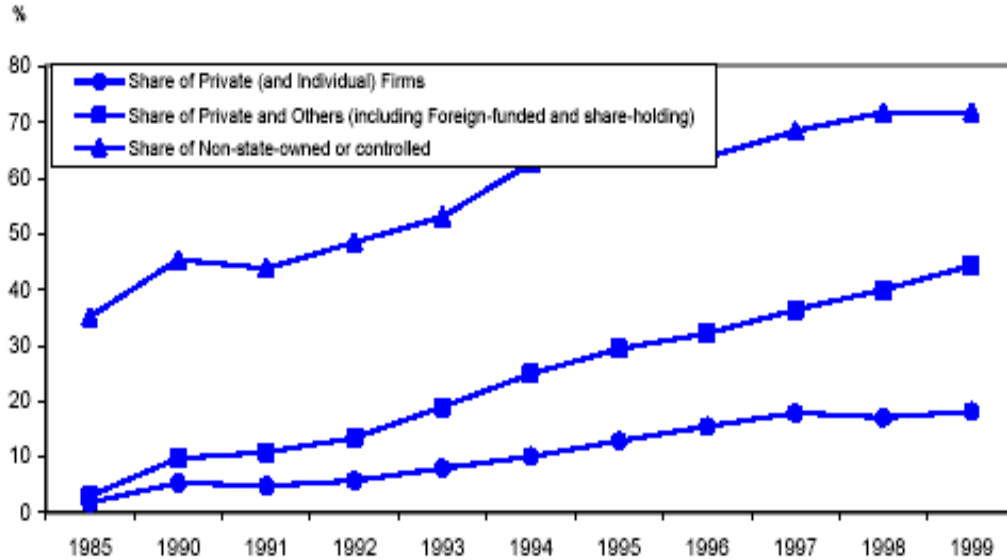
China's growth continues to be remarkable. In 2003, despite the global slowdown, China's economy continued to grow at an annual rate of about 9,1%. Defying the perception that China has reached a plateau of growth, more and more economists (Maddison, 1998; Qian, 2002) start to believe that the best period of China's growth has not come yet. With the entry into the World Trade Organization (WTO), they suspect that China's economy is on the verge of another economic boom (Qian, 2002).

According to Maddison's (1998) calculation, China might overtake the United States in total GDP in terms of Purchasing Power Parity (PPP) by 2015. If Maddison were right, China would be the only economy, excluding European Union, capable of surpassing the US economy (in Purchasing Power Parity) within the next two decades. And this would make China the largest economy in the world, regaining its historical position that it lost in the middle of the 19th century. No wonder Summers (1992) speculated in the early 1990s: "It may be that when the history of the late 20th century is written in a hundred years the most significant event will be the revolutionary change in China" (p.7).

### *The change of ownership structure*

The general opinion is that to a very large extent the driving force behind China's spectacular economic growth has been the emergence of non-state-owned sectors, especially of a dynamic private sector (Asian Development Bank (ADB), 2003). China's State Statistical Bureau (SSB) presents data for seven different classes of enterprise ownership: individual ownership, private ownership, foreign ownership, joint ownership, shareholding corporations, collective ownership, and state ownership (see Chapter 3). Though the information is not uniformly available about all of the indicators of these classifications, the conclusion is unanimous: compared to the stagnant state-owned economy, the non-state-owned sector has become the most important source of the dynamics of the Chinese economy.

**Figure 1.3 Share of Non-state-owned Sector in Total Gross Industrial Output in China (1985, 1990-1999)**



Source: Asian Development Bank (2003, p.66)

Notes: After 2001, the China Statistical Yearbook did not report the total gross industrial output data by the ownership; this figure covers only the period until 1999.

Since 1985, the non-state-owned sector has made an increasing contribution to the growth of industrial output. As Figure 1.3 illustrates, non-state ownerships, including individual firms, private firms, joint ventures, and collective-owned enterprises and others forms of ownership<sup>3</sup>, have comprehensively outpaced the state-owned sector in the past 15 years (see Chapter 3). The persistent growth differentials have translated into a significant shift in composition of the level of industrial output by ownership types. In 1985, almost two third of gross industrial output was produced by state-owned firms and one third by non-state-controlled firms (Qian, 2002). Since then, the shares being produced by non-state-controlled firms have risen rapidly. The International Finance Corporation (IFC, 2000) reported about the composition of ownership in the Chinese economy in 1998. Based on official statistics and assumptions about ownership shares in different sectors (agriculture, industry, construction, transport, post and telecommunications, wholesale and retail trade, and others), the IFC estimated a share of 62% of total Gross Domestic Product (GDP) produced in the non-state-owned sector. IFC deduced that in 2002 the share of GDP produced in the non-state-owned sector would exceed two-thirds, with a share produced by truly private activity of more than half. In its 2001 White Paper, the American Chamber of Commerce (ACC) in

<sup>3</sup> Other ownership types mostly comprise foreign-funded firms and non-state-controlled shareholding corporations.

## *Chapter 1*

the Peoples Republic of China (PRC) confirmed that the size of the non-state-owned sector was two thirds of GDP in 2000 (ACC, 2001). The most recent data from the Asian Development Bank (2003) showed that the share of GDP produced in the non-state sector in 2002 exceeded two thirds, with the share produced by truly private activity comprising comfortably more than half.

### **1.1.2 China's challenges**

China is very likely to be one of the world's fastest growing economies over the next two decades. However, because of its sheer size and population, China will still have to struggle with social, economic and political challenges for a long time.

#### Challenge 1: the economy

##### *Economic growth*

In 2003, China's GDP growth rate was 9,1% (China State Statistic Bureau, 2004). Even if China's economy is assumed to grow at this rate annually for three decades, its GDP per capita in 2030 will still only be around \$3.000. Consequently, China will still be a developing economy in the next 30 years. Several economic issues demand attention.

##### *Currency*

Outsiders rebuke the government that the Chinese national currency, the Renminbi, which is pegged to the US\$, is substantially undervalued, due to large and persistent gains in manufacturing productivity and the resulting price deflation. However, the Chinese government attributes it to the productivity increase and the low cost of inputs. It is unlikely that the Chinese government will change the system, as it appears to be a conscious development strategy (similar to Japan in the 1970's): the cheap currency supports the high economic growth that is needed to cope with the pressing issues such as rising unemployment, restructuring of State-Owned Enterprises (SOEs) and the fragile financial sector.

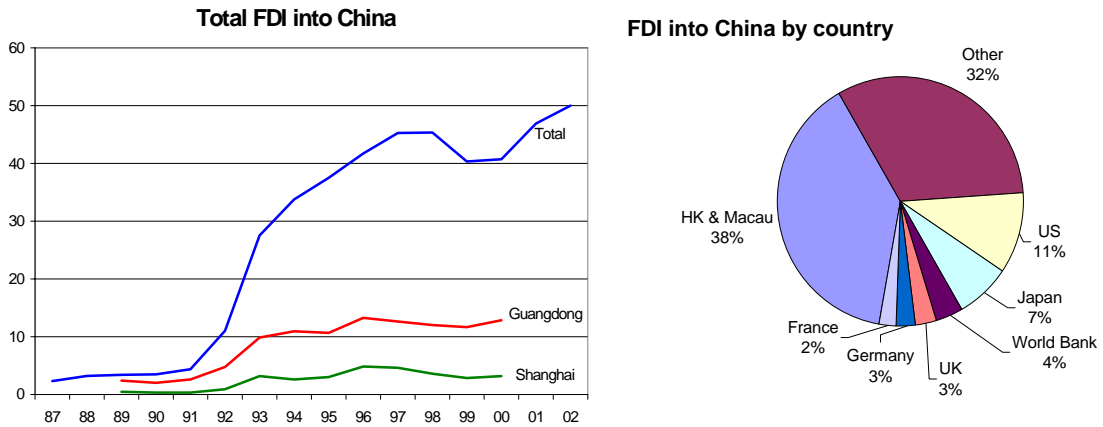
##### *Foreign Direct Investment (FDI)*

FDI remains crucial for China's economic outlook. Recent data show a continued steady increase in total FDI. Even with its economy slowing, China remains the corporate world's favourite destination. Actual foreign direct investment (FDI) rose to \$34 billion in the first half of 2004, and is on course to exceed \$60 billion for the year (The Economist, August 7<sup>th</sup>, 2004). Guangdong province (closest to Hong Kong) continues to be the main recipient of overseas funds (see Figure 1.4; the



Taiwanese investments are included in the figures of Hong Kong in official classifications).

**Figure 1.4 Foreign Direct Investments**



Source: DataStream

### *Labour market*

Employment remains a priority on China's policy agenda. Enterprises with profit making as their main concern have been laying off workers for cost-effectiveness. The number of unemployed workers is increasing. The official urban unemployment rate rose to 4,3% in 2003, but this figure is widely acknowledged to be a serious understatement. Workers who are "laid off" (*Xiagang*) by state- and collectively owned enterprises (even though they are not paid) are technically not considered to be unemployed. There are no official statistics of laid off workers. Quite a number of foreign scholars estimate that China's actual urban unemployment rate could be higher than 10% (Giles et al., 2004). Urban unemployment is likely to continue to rise steeply due to (1) further SOEs restructuring, and (2) the migration of rural workers to the cities. The capacity of the labour market to absorb an extra 40 million job seekers over the next few years will depend critically on the pace of economic growth, the development of the private sector and the progress made with respect to structural reforms, especially concerning measures to improve labour market flexibility through job hunting systems and re-training programs. The danger of urban unemployment rising to over 20% of the labour force highlights the urgency of the government to continue developing a national unemployment insurance scheme.

## Chapter 1

### *Fiscal position*

From the officially published figures China's fiscal position seems healthy. The reported public debt is around 25% of GDP, while the interest burden as a percentage of government revenues are around 5% (China State Statistic Bureau, 2004). Still, rating agency Standard & Poor's only gives a BBB rating to China's long-term debt, while the above figures would warrant at least A+ (Hong Kong's rating). The low rating is due to doubts about the validity of the statistics. The official figures are considered misleading. For instance Steenbeek (2003) reported that:

- The fiscal deficit is currently at 10% of GDP;
- The banking sector, which is mostly state-owned, is *de facto* bankrupt. Cleaning up the non-performing loans (NPLs) is expected to require up to \$500 billion, or 40% of GDP;
- Fixing the fragile rural financial system will cost another US\$60 billion or so;
- The State-Owned Enterprises are mostly in very bad shape. At least another \$400 billion is required to restructure these conglomerates and to create some kind of social safety net.

Whereas China seems to be fiscally weak there is also a positive side: the Chinese government possesses a large amount of assets, e.g. around two thirds of the total stock market capitalization (two thirds of US\$750 billion = US\$500 billion). The problem is how to sell these assets without disturbing the fragile markets.

### Challenge 2: The financial sector

The Chinese banking system has the most serious problem in the world (Dornbush and Giavazzi, 1999). The weak state of China's financial sector is inextricably linked to reckless lending to the high-risk SOEs. The banking sector is a major source of vulnerability for the China's economy, partly because its assets are highly concentrated in the four state banks, but also because its sources and uses of funds are so limited.

#### *Non-performing loans (NPLs)*

According to the annual reports from four state-owned banks in 2003, the total NPL problem was around US\$232 billion, or 20,4% of 2003 total loans or about 16,5% of 2003 GDP. This is a conservative estimate as further SOE restructuring is likely to discover new NPLs. Moreover, the NPL problems in the non-bank financial sector (about 20% of the financial sector) are ignored in this figure, which are as bad if not worse.

### *Financial crisis*

An outright financial crisis is unlikely as China's currency is not fully convertible, making it difficult for ordinary Chinese citizens to move their money abroad and impossible for foreigners to move money into or out China's stock markets (see Chapter 6 for B-shares being quoted in HK\$ and US\$). China also has a trade surplus, limited short-term foreign debt and large inflows of foreign direct investment, and it has the largest foreign exchange reserves in the world (US\$470.6 billion on June 30<sup>th</sup>, 2004) (Peoples Bank of China, July 14<sup>th</sup>, 2004).

### Challenge 3: Regional differences

One may divide China into three main regions: (1) the coastal provinces, (2) the Northeast, and (3) Western China. The coastal provinces in the East of the country are home to about 300 million people, and represent the engine of China's economic growth. Guangdong province, across the border from Hong Kong, is the most developed. As this province is starting to look like Hong Kong and becoming more expensive, more and more Multinational Companies (e.g. Nike) are moving further up the east coast, looking for cheaper subcontractors. High tech companies, many from Taiwan, appear to concentrate around Shanghai (also for language reasons). In the coming decades, Hong Kong will remain an important service centre for Mainland China. Despite the high costs, foreign companies will continue to choose for Hong Kong because of its well-developed legal framework and overall infrastructure.

Northeast China is usually called the "rust-belt" as most of the inefficient state-owned heavy industries are located there. It is the home to about 120 million people. There is increasing social unrest as more and more people lose their jobs in the ongoing restructuring process.

Western China, home to about 800 million people, is highly dependent on agriculture. Officially, only 150 million people are below the poverty line, but this region has been in recession for quite some time. In addition, the gap with the rich coastal provinces is getting larger and larger. It will take a while before these people are active consumers. A number of issues in this by far largest part of the country pose major challenges to the government in Beijing (Steenbeek, 2003):

Most of Western China is not suitable for agriculture at all: most of the area is either desert or mountainous and the remaining 10% is not ideal either. Lost crops and impoverished people (especially relative to their compatriots on the coast) are potential sources of social unrest.

- High and rising unemployment: a large proportion of the 500 million rural workers, possibly as many as 120-150 million workers, are unemployed. So far, the rapidly expanding non-state sector and the introduction of reemployment centres have helped to absorb the rising numbers of

unemployed. According to the Ministry of Labour and Social Security, the non-state-owned sector has provided more than 95% of the nation's new job opportunities over the past 10 years. However, this absorption capacity will be tested in the coming years: the World Bank recently projected that China will need to create 90-100 million jobs over the next decade, just to keep the unemployment rate steady.

- The rural financial system is very fragile and will need significant government support.
- The large Islamic community in Western China has become more demanding and poses a threat to stability.
- China borders directly at a number of instable Central Asian nations, such as Afghanistan, Tajikistan and Kazakhstan. Consequently, a large part of the costly Chinese army can be found in the far West.

### **1.1.3 Restructuring the corporate sector: the role of mergers and acquisitions in China**

Although the transition in China is in general considered being of an incremental nature (see Chapter 3), the business environment after 1979 has changed dramatically. Before the reforms, the SOEs were the backbone of the national economy. In 1978 eight million SOEs contributed to 77,6% of China's total industrial output and they owned two-thirds of the assets. The SOEs then employed 60% of the urban labour force (Qian, 2002). Because of the lack of the market mechanism (see Chapter 2 and 3), SOEs made a huge loss that totalled RMB 79 billion in 1996, comparing to only RMB 4.2 billion in 1978 (China Statistical Yearbook, 1997). In 1985, one out of ten SOEs admitted losses; by 1998 it was one out of two. Meanwhile the state sector still dominates the category of large enterprises and monopolises important industries, such as banking, transport and the military industry. Some drastic decisions had to be taken in order to restructure the SOEs. Basically there are two options: bankruptcy or merger and acquisition (M&A). Bankruptcy would split the SOEs into different components, which are put into the market and combined with other assets. The second option of M&A does not decompose the enterprise but allows it to be restructured by other mostly financially healthier firms. To merge with an unhealthy SOE or to take-over the SOE, offers a possibility for other firms to become independent economic players too. The Chinese government does not favour the option of bankruptcy, because that would cause instability to society, whereas M&A is thought to be an effective approach to save inefficient SOEs. As will be explained in Chapter 3, the Chinese government stimulates the money-losing SOEs to merge with healthier enterprises and underlying government's strategy is the will to keep control over the enterprises. In Chapter 4 the institutional arrangement of M&A is discussed and in Chapter 5 the effects of M&A on the listed SOEs are investigated.

The term “M&A” refers generically to any combination of two or more business enterprises. An acquisition usually means that a company buys another company and absorbs it. For example, ING Bank (bidder) buys Barings (target), Barings is not listed on the stock exchange anymore and becomes part of ING, which remains listed. In the case of a merger, Nationale Nederlanden and Postbank, almost equal in size (both bidder and target), merged into a new company ING Group that absorbed the former two and got a listing on the exchange.

However, “merger” and “acquisition” are defined differently in China. According to the Chinese Company Law, a “merger” (*Jianbin*) is the legal combination of two discrete economic entities in which only one entity survives. Two forms of merger are involved: first, merger by absorption (*Xishou Hebing*), in which one company absorbs one or more other companies and the absorbed companies are dissolved, and second, merger by establishment (*Xinshe Hebing*), in which two or more companies are merged into a newly created company and the parties to the merger are dissolved. So the difference is that in the first case the absorbing firm continues to exist, whereas in the second all firms dissolve into a new one.

On the other hand an “acquisition” (*Shougou*) can be defined as the purchase by one economic entity of all or part of the shares or assets of another economic entity. In the most recent Chinese regulation (2002) on M&A, *Administrative measures relating to acquisition of listed companies*, the acquisition of a listed company is defined as:

*“the act of acquiring shares in the listed company by an acquirer by means of share transfers at a stock exchange, or the act of acquiring control of shares in the listed company by means of lawful activities other than share transfers at a stock exchange, whereby shares held or controlled by the acquirer in the listed company reach a certain level degree as would result, or would be likely to result, in the acquirer achieving de facto control over such listed company. An acquirer may carry out an acquisition of a listed company and obtain de facto control over it by means of acquisition by agreement, acquisition by offer or competitive bidding on a stock exchange” (Article 2).*

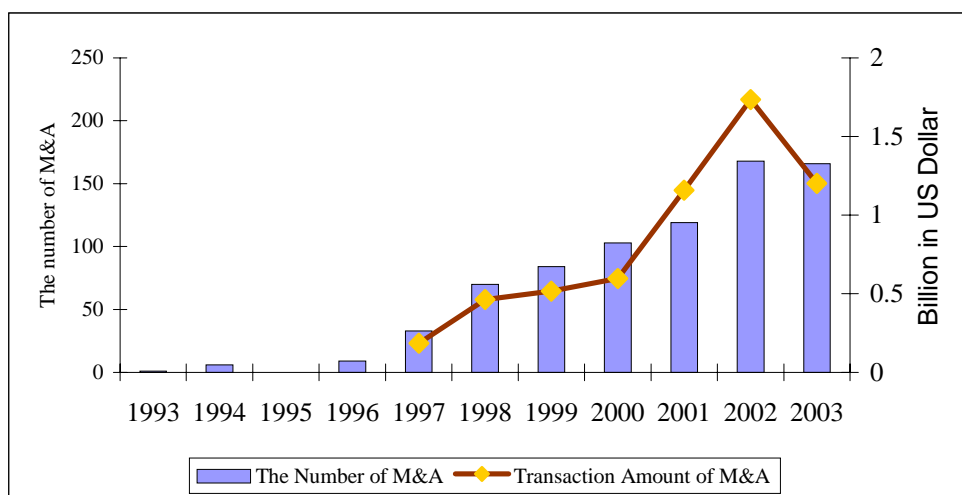
Unlike the acquisition in the western countries, China’s target companies may lose formal control after the acquisition, but they remain a separate entity that has an individual listing on the stock exchange. So both economic entities survive after the purchase. In China an acquisition means the acquiring firm owns such a part of the shares that it controls the other firm, which continues to be separately listed on the stock exchange.

Mergers, virtually unknown under the pre-reform system of socialist planning, first appeared in 1984. Early M&A in China was arranged by the government in the mid-1980s, whereas M&A on a large scale took place after 1988. The M&A was then still under the guidance of the government and its result was less than

satisfactory (Dong and Hu, 1995). From the late 1980s, the government induced market-like approaches into the reform of SOEs: bankruptcy and “free-market-style” M&A. The bankruptcy experiment failed because there was no social insurance system for unemployed workers, whereas private enterprise growth was not fast enough to offset the firing of people by the SOEs. In the meantime the M&A market became more important for not only SOEs but also for private Chinese and foreign enterprises. The scale at which this takes place increases.

Although there are no comprehensive statistics of transactions of property rights through M&A, partial information confirms that the scale of activity has increased rapidly. Government agencies state that 6,900 firms were acquired during the 1980s involving total assets of RMB 8 billion (Asset Yearbook 1996, p. 355). The volume of assets involved in mergers and bankruptcies in 1997 is 100-fold of that in the mid-1980s, amounting to 6,9% of the asset total of the state-owned industry and 3,8% of the stocks of all state enterprises (Asset Yearbook 1997, p. 402). This means that about 2% of China’s total reported industrial and commercial assets is involved. According to the most updated statistics, the deal value of M&A in China reached to \$25 billion in the first half of 2004 while the number of deals to 451 (The Economist, July 17<sup>th</sup> 2004). Our research will specially focus on the role of M&A in the process of transition of the Chinese economy. Figure 1.5 gives an indication of the importance of M&A.

**Figure 1.5 M&A in China’s Stock Market**



Source: Data are from *China Merger & Acquisition Review*, Vol. 4, 2003.

## **1.2 The Research Question: Institutional Economics and China's Reform**

Institutions as shown in Figure 1.1 are important to economic life: economic exchanges do not function in a social vacuum. Economic practices are embedded in rules, routines and conventions. Indeed, the type and quality of institutions make a great difference to how the economy is organised and develops (North, 1990; Whitley, 1999). In reality a two-way relationship exists between institutions and individuals: there is an effect of institutions on individuals, as well as a transformation of institutions through individual actions. In theory different models with respect to the relationship between individuals and institutions are applied. As indicated above two schools of thought exist in institutional economics: the NIE and the OIE. Their research questions, philosophy and research methods differ substantially (Rutherford, 1994). Based on Figure 1.1 three positions can be distinguished (Eggertsson, 1996; for a more detailed account see Chapter 6):

1. both the (in)formal institutions and the institutional arrangements are exogenous: in a comparative static way the consequences of different mixes of institutions on the performance of sectors, regions, or countries is investigated.
2. in the NIE the institutional arrangements are endogenous: contract and organisation are to be explained given the (in)formal institutions, which are now called the institutional environment. (Williamson, 1985; North, 1990). Preferences are stable in this theoretical framework, which is based on an methodologically individualistic approach of mainstream economics.
3. Both (in)formal institutions and arrangements are explained in an interactive way. For the analysis of institutional change, the analysis of circular processes is needed: Eggertsson provided the following illustration:

*“Consider an exogenous change, such as a technological change or a change in world markets, which upsets the political equilibrium in a community, causing changes in economic policy (institutional change). A change in economic policy usually creates winners and losers. The effects of the change create a new economic equilibrium which feeds back to the political system, as winners and losers lobby political organization, possibly giving rise to new economic policy measures that create a new economic equilibrium, and so on” (Eggertsson, 1996, p.12).*

The implication is that preferences are no longer exogenous and that the process of institutional change is a matter of bargaining, which make the analysis of vested interests and power relations necessary. Moreover, both political and economic actors can learn over time. All this has large implications for the modelling of the individual and of the relationship between individual and environment. As will be

discussed in more detail in Chapter 6 the different models and approaches can be reduced to two paradigms: the neoclassical and new institutional one on the one hand and the original institutional one on the other. The former is well equipped to study questions of a comparative institutional nature, the latter for issues of the dynamics of institutions. The former belongs to the mainstream economics based on methodological individualism, (bounded) rational agents and reduces explanations to issues of efficiency, whereas the latter belongs to heterodox economics based on methodological interactionism, contingently and procedurally rational agents and opts for a full interdisciplinary explanation of the question at hand.

In this thesis both streams of Institutional Economics play a role. We first present the central research question of this thesis; we then give a brief overview of the two streams, and discuss the research methods before presenting the structure of the thesis.

### **1.2.1. The research question**

Chinese reforms contributed to an impressive economic development. The reforms have not resulted into a coherent set of institutions, which is normally found in a successful market economy. China typically follows its own path of development in which firms, markets and government interplay. The research in this thesis focuses on understanding the process of Chinese institutional change in the last three decades with specific attention paid to the transition of SOEs and the role of M&A in that process. The central research question is:

**What kind of institutional changes took place in China's economic system after 1979, how to characterise its transition process from a dynamic perspective and what are the consequences for the Chinese economic system?**

The central research question can be divided into the following sub-questions:

Q1. How did the Chinese economic system work in the pre-reform period?

From an institutional perspective it is important to analyse the history of a system, because the past largely constrains developments in the present and future (path dependency).

Q2. How to characterise the process of change?

This question aims at understanding the nature of the process of institutional change; what are the important changes in the cultural, political and economic system? Is it incremental, or also revolutionary?



Q3. How to characterise the present stage of the transformation towards a market economy?

In the research there is special attention for Mergers and Acquisitions, because these imply an important change of the property rights.

Q4. How will the processes of institutional change since 1979 influence the future changes in the Chinese system?

### **1.2.2. The theoretical framework**

Eggertsson (1996, p.6) argued in his “Note on the Economics of Institutions” for parsimony and pluralism, for combining the best of all worlds:

*“I argue for parsimony in structuring theories and a standardization of theoretical terms, but I also argue for the economic principle of judicious substitution at the margin when research methods are selected. As I see it, the maximization of net output in research requires a flexible use of the inputs, the matching of tools to the tasks at hand, while recognizing at the same time that eclecticism is not a free good.”*

This connects to the point made by Groenewegen and Vromen (1996) on “different theories for different issues” and “different theories for different conditions”. The idea is that in a pluralistic approach (in contrast to a monistic one), there is room for different approaches designed for different research questions (issues) and which are relevant under different conditions because of the assumptions made about for instance the type of actors, the information they possess, the competitive environment in which they operate, and the like. As will be discussed in Chapter 6 the theories at Level 2 (Property Rights), Level 3 (Transactions Costs Economics) and Level 4 (Agency Theory) can be grouped together as NIE (Eggertsson, 1996; Groenewegen, 2004), while the theories at Level 2 (political science) and Level 1 (history, anthropology, cultural theory, sociology) can be grouped as OIE. For our research question insights of the NIE seem relevant with respect to the issue of incentives, principal-agent relations and governance structures. We will not apply the NIE in its original way and not test hypothesis deductively, but use the insights offered by the NIE as far as these seem relevant for understanding the dynamics of the institutional development in China. The core of our theoretical framework will be the OIE, in which is room for the dynamics of institutional specificities of place (China) and time (1979-2004).

Below we first pay attention to the three building blocks of the NIE: property rights, agency theory and transaction cost economics. In general the NIE differs from traditional Neoclassical Economics (NCE) with respect to the attributes of actors: bounded rationality and opportunism, which makes complete contracting impossible.

## Chapter 1

### *The Property Rights Perspective*

The theory of property rights emphasises the importance of clearly defining property and contractual rights. It suggests that if property rights are well defined and if the legal system enforces those rights, then private agents will negotiate efficient outcomes. Citing Alchian, Coase and Demsetz, Eggertsson (1990, p.33-35) articulated the concept of property rights as:

*“We refer to the rights of individuals to use resources as property rights. A system of property rights is ‘a method of assigning to particular individuals the ‘authority’ to select, for specific goods, any use from an unprohibited class of uses . . . ’ It is common to distinguish three categories of property rights: First, there are the rights to use an asset--user rights--which define the potential uses of an asset that are legitimate for an individual, including the right to transform physically or even destroy an asset. We should note that restrictions of rights that shrink the set of permissible uses will lower the economic value of an asset if highly valued uses are excluded. Second, there is the right to earn income from an asset and contract over the terms with other individuals. Third, there is the right to transfer permanently to another party ownership rights over an asset--that is, to alienate or sell an asset.”*

Coase (1960) provided a fundamental insight into the role of private property rights and Kornai (1980) examined the implications of their absence. Rapaczynski (1996, p. 87) stated:

*“It is an old saw of the economics profession that markets require a clear assignment of initial rights to most resources and well enforced rules of contract. [This suggests that] governments intent on fostering a market economy should thus make sure to put an effective legal system in place, one in which property rights are unambiguous, secure and freely alienable.”*

In contrast to Central and Eastern Europe and the former Soviet Union (CEEFSU), the Chinese government experimented with different types of ownership. “Instead of rapidly moving towards a system in which private property became a dominant form of ownership, China in the 1980s was committed to experimentalism and gradualism in ownership reform” (Nolan, 1993, p. 74). The popular word “pick-ism” (*Nalai Zhuyi*) reflected China should adopt all useful elements from different models. The result was that “in all important areas of the economy, transparent, legally protected individual property rights were the exception, not the rule. Public ownership with confused property rights was the norm” (Nolan, 1993, p. 74). The World Bank (1990, p.149) criticised that “the ownership of Chinese ‘state-owned’ enterprises is becoming increasingly ill defined . . . The uncertainty surrounding the ownership system is putting serious obstacles in the way of improved performance”.

However, it is now widely recognised that China's reforms have been a lot more successful than those in CEEFSU since China has kept the high growth rate for more than 25 years. To understand what role the property rights structure played we will use in this thesis insights from that part of the NIE.

#### *Agency Theory Perspective*

Agency theory builds upon the theory of property rights as developed, among others, by Alchian and Demsetz (1972). The incentive problems arising from a separation of management and ownership should be solved through implicit or explicit contracts, in which individual rights are well specified so costs and rewards are clearly allocated among the participants in the firm and the economic system at large. How agents (managers) behave depends on the contracts they have with the principals (political rulers, bureaucrats, owners). This general idea is elaborated in agency theory resulting in the firm as a multitude of complex relationships (i.e. contracts) between the legal fiction (the firm) and the owners of labour, material, and capital input (Jensen and Meckling, 1976). The conflicting interests between the stakeholders are brought into equilibrium within a framework of contractual relations. Owners will discipline management through monitoring or bonding contracts, which create incentives for management to serve the interests of the owners, i.e. to maximise the value of the firm in the interest of the owners.

An important insight offered by agency theory is the case of information asymmetry and divergent objectives between agents and principals. For the research question of this thesis that is relevant for analysing the relationships between political rulers, bureaucrats and managers.

#### *Transaction Cost Economics Perspective*

Transaction Cost Economics (TCE) takes the transaction as the basic unit of analysis. The centre of transaction cost economics is that economic institutions are determined by “the economizing role of organizations” (Williamson, 1985, p.xii). The aim of transaction cost economics is to “align transactions (which differ in their attributes) with governance structures (which differ in their cost and competencies) in a transaction cost economizing way” (Williamson, 1990, p.67). Williamson (1990) therefore argued that the change of organisation form, including market, hybrid and hierarchy, could be explained by different cost structures.

There are different organizational forms because transactions have different dimensions: the frequency with which transactions occur, the degree and type of uncertainty to which they are subject, and the condition of asset specificity (Williamson, 1985, p.52-63).

Williamson (1985) argued that the most important issue was not whether private property rights exist but the extent to which they are secure. However, Williamson (1991) also admitted that “individuals faced with security hazards to their legal

## *Chapter 1*

rights posed by expropriation by the government and commerce (rivals, suppliers and customers) will mitigate the potential costs via contracting into alternative organizational forms to the market rather than rely exclusively on the courts” (Williamson, 1991, p.288). Williamson (1998) stressed the importance of credible commitments. In the terminology of Williamson: “when the institutional environment is right”, both informal and formal institutions motivate agents to minimise costs, then TCE can predict which governance structures will emerge. In this thesis we will not apply TCE in that way, but as we will use the insights offered by property rights and agency theory, we will apply the insights offered by TCE to understand the reforms in the Chinese economy.

For our research question about the dynamics of the institutional structure in the specific institutional context of China in the period 1979-2004, we agree with Eggertsson and others that a different theoretical paradigm should complement or replace the NIE.

### *Theories of Original Institutional Economics*

In Figure 1.1 Williamson (1998) linked the analysis of the first layer to what he calls “social theory”. We prefer to use the label of Original Institutional Economics (OIE), because that heterodox paradigm seems to be better equipped to study the dynamics of institutions. Based on the insights offered by Veblen, Commons and Ayres (American Institutionalism), the OIE advocates an analysis of the dynamics of institutions that is “evolutionary, holistic and systematic” (Wilber and Harrison, 1978). An evolutionary process results from agents taking initiatives to improve their welfare by improving institutions, or by replacing them. In doing so agents are supposed to learn and to bargain. Cognitions and power relations are important to understand individual behaviour. The process that starts from below can be facilitated or hindered from the top: the suppliers of institutions (mainly the state) acts at the second level in Figure 1.1. Developments can become very complicated when the state (politicians and bureaucrats) tries to realise its own interests by maintaining or changing institutions. Moreover, there is the ideology, or culture at Layer 1: the “mental maps” of individuals (Denzau and North, 1994) are continuously moulded by developments at Level 1, whereas the actions of the individuals have a feedback on the ideology. In the fullness of time all layers are interrelated (Williamson, 1998). “Holistic” and “systematic” refer to the need to analyse the system in its totality in order to understand the nature of the evolution; a partial analysis which is so characteristic for neoclassical and NIE, presents a too distorted picture of the dynamics. Politics and economics, as well as ideology and their interdependencies should be included. In Chapter 6 we will discuss the characteristics of the OIE in more detail. For the moment it is sufficient to state that the insights offered into the interdependences between the four layers in Figure 1.1 seem appropriate for our research question. We should focus on bargaining (power), learning, and changing ideologies.

### **1.2.3. The research method**

Among others Wilber and Harrison (1978) and Caldwell (1980), showed what kind of research methods fit an institutional analysis. The axiomatic deductive analysis is applied by the NIE, whereas the so-called “pattern modelling” fits the OIE. Three approaches seem relevant (Eggertsson, 1996):

1. Comparisons across countries, sectors and regions; a different institutional structure results in a different performance. General hypothesis: when property rights are not well defined, and/or transaction costs are high to coordinate transaction among anonymous actors, specialisation is not sufficiently taking place with consequences for productivity. In this research we do not use the comparative method; apart from a few illustrations of soviet type economies, we only study the Chinese system.
2. Quantitative research in which for instance the power of certain groups is measured and the change of the institutions is matched with the powerful groups in order to test the hypothesis that the powerful will largely determine institutional changes. In this thesis we undertake a statistical research in Chapter 5 concerning relations of firms listed on the Chinese stock market.
3. Case studies and qualitative historical research which helps to understand the process of institutional dynamics and helps to generate hypothesis and building a theoretical framework in which different theories complement each other. In this thesis we use the method of a longitudinal case study of the Chinese political-economic system with a focus on the developments in the State Owned Enterprises (SOEs), and the systems of corporate governance including M&A.

The research method followed in this thesis also has a clear limitation. A full understanding of the changes in the Chinese institutional arrangements of SOEs and M&A would require an analysis in which the layers of Figure 1.1 are fully interconnected. Informal institutions shape and constrain the formal ones that set the boundaries for the institutional arrangements, which then are applied by individual agents in the economic and political arenas. Endogenous and exogenous variables make individuals and groups invest in changing the arrangements, which has an impact on the (in)formal institutions. In an analysis in which the layers are fully connected, trial and error (learning), bargaining and changes of the mental maps should all simultaneously be analysed. In this thesis the focus is on the consequences of the changes in the formal institutions of laws and regulations on the institutional arrangements of specifically the SOEs and M&A. The drivers of the processes are identified and an attempt is made to dig out the mechanisms that make the institutional changes take place. We touch upon the feedbacks of changing mental maps and politics and we hardly pay attention to the feedbacks to

the formal and informal institutions. This clearly is a limitation that will be further discussed in Chapter 6.

### **1.3 Overview of the Thesis**

This thesis consists of 3 parts and 7 chapters. The structure of the thesis is presented in Figure 1.6. The first chapter contains an introduction to the research question, the theoretical framework and the research methods.

China's transition to a market economy seems to be a gradual, path-dependent evolutionary process, resulting in nevertheless dramatic changes. To understand China's transition, it is necessary to review the historical roots of the centrally planned economy that existed from 1949 to the end of the 1970s. Chapter 2 studies how the economic system worked in China's Centrally Planned Economy (CPE). In the planned economy, economic planners of central and provincial governments had great power in allocating resources and in the distribution of goods and services. Public ownership dominated the economy. Private firms and "free" markets were absent. In the command system, the enterprise was regarded as a production division, which took orders from the planning regime. The government appointed managers and financed firms' project and managers did not have decision rights. In those years, institutions were clearly formed, which influenced the mental maps of politicians, bureaucrats and managers with consequences for the developments after the reforms.

Chapter 3 describes the process of China's reform. The Third Plenum of the 11th Congress of the Communist Party of China, which was held in December 1978, marked the beginning of the transition to a market-oriented economy. Economic development was set as the prime goal of the nation and far-reaching economic reforms started after that meeting, following an approach of piecemeal social engineering. Though Chinese reform is often criticised for its unsystematic (even chaotic) approach, China showed a remarkable success in the first 15 years. Especially China's agricultural output grew at an unprecedented rate, after the "Household Responsibility System" was introduced. After November 1993, China was guided to a "socialist market economy". A series of well-planned radical changes in policy, such as the tax regime, the financial system and the social security system, were launched. At the same time, China was on its way to a radical transformation of property rights and corporate governance, including privatisations in the agricultural sector, restructuring state-owned enterprises and promoting the non-state sector with private firms. The process of transformation is far from successful: especially great difficulties exist in restructuring large-scale SOEs.

Chapter 4 and 5 pay special attention to Mergers and Acquisitions (M&As) in China, which imply an important change of the property rights. Chapter 4 explains the emergence of Mergers and Acquisitions during the transformation process and provides a description of Mergers and Acquisitions activity in the two national stock markets. Since the mid 1980s, experimentation with mergers and acquisitions in China began with small firms. In 1990s, more and more large enterprises became subject to a change of ownership rights through M&A. The Chinese stock market provided a growing stage for M&A.

Chapter 5 contains three empirical studies of Chinese M&A. The first tests the effect of the takeovers on the target companies' stock price; the second examines the financial performance of target firms during M&A period and the third studies whether managers will drive mergers in line of their own objectives. The research focuses on Chinese companies listed on the two national stock markets – Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE). Based on the list of shareholders disclosed in the annual reports of listed companies, we scanned all companies that published a change in their largest shareholder between 1997 and 2003. We selected 14 merger cases and 207 acquisitions cases. The financial analysis and the event study are useful tools to gain insight into the motives and the effects of M&A in China.

Chapter 6 interprets the findings of the previous chapter using the theoretical framework of which the outline is discussed in the beginning of Chapter 1. In Chapter 6 a more detailed account is given of the developments in NIE and OIE. Special attention is paid to the findings with respect to path dependency, power relations, and mental maps. We also try to conceptualise institutional change in order to contribute to the building of a theoretical framework appropriate to study institutional change in more general terms. In terms of Figure 1.1, we analyse in Chapter 6 the changes in informal institutions, formal institutions and institutional arrangements and show how the Chinese economic system after the reforms largely depends on the structures that existed in the previous stages.

Chapter 7 draws conclusions with respect to the research question and the sub-questions posed in Chapter 1. On the one hand conclusions are drawn concerning the development of economic systems in general, and with respect to the Chinese case in particular, while on the other hand Chapter 7 draws conclusions about the appropriate theoretical framework to study the dynamics of institutions.

**Figure 1.6 Overview of the Dissertation Structure**

